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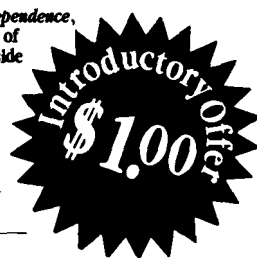
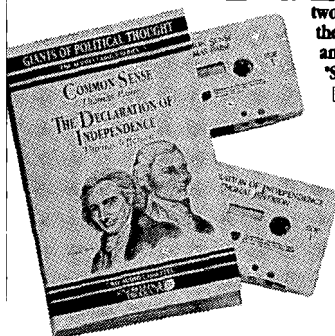
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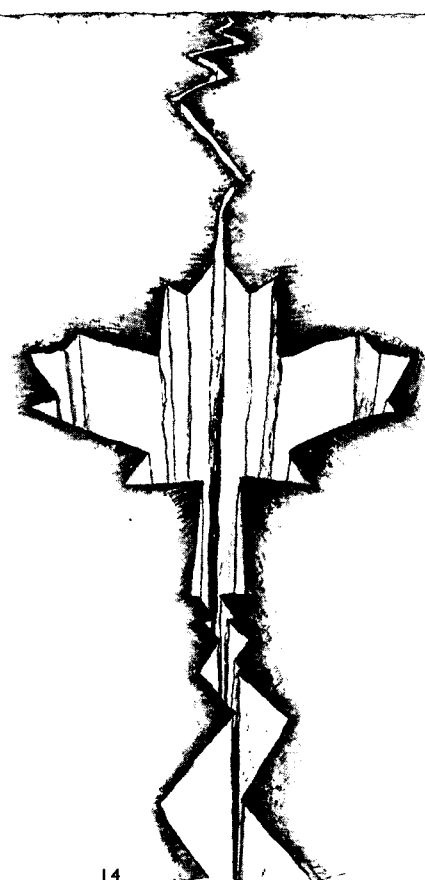
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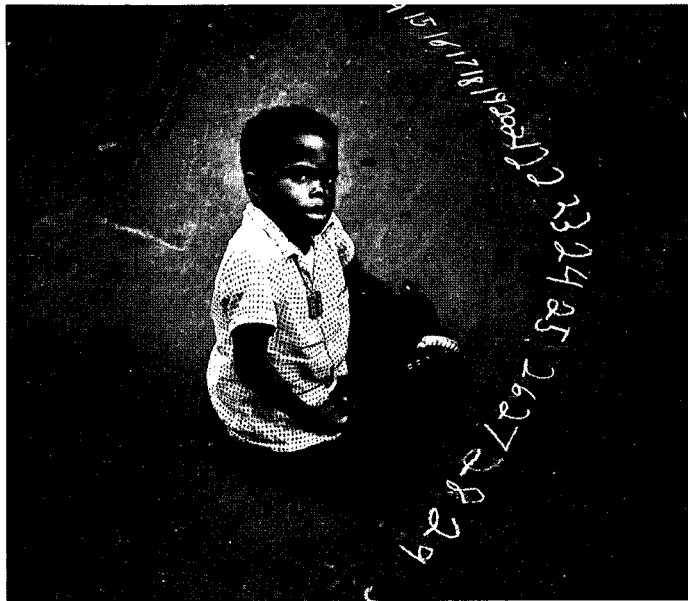
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What Makes a Poverty Program Work?



■ Programs that are successful in helping children and families climb out of poverty have many common attributes. But, as Robert Greenstein ("Relieving Poverty," summer issue) argues in refuting Theda Skocpol ("Universal Appeal"), whether programs are targeted on the poor alone or are more universal in scope is not the major determinant of success.

The public seems ready to support programs of proven effectiveness. Service effectiveness depends on the nature and quality of the services themselves. The research findings of the past 20 years increasingly converge to suggest that effectiveness in improving the life chances of disadvantaged populations depends on the extent to which services are comprehensive, intensive, flexible, high-quality, family-focused, community-based, provided in an atmosphere of trust and respect, and designed to respond to the distinctive needs of the seriously disadvantaged. These attributes characterize successful programs of prenatal care, child health, family planning, parent support, child welfare, day care,

preschool education (including Head Start), job training, and effective schools.

Greenstein is absolutely right that an antipoverty strategy for the 1990s must include a mix of universal and targeted programs, and that we must act on the clear knowledge that health, education, and social service programs will succeed in helping the truly disadvantaged only if they are not diluted, depersonalized, or underfunded.

*Lisbeth B. Schorr,
Harvard University*

Fighting Poverty: What Works is Work

■ Theda Skocpol's "Universal Appeal" mistakes the political problem faced by antipoverty policy in America. The difficulty is not that programs aimed just at the poor lack support or that universal programs are too costly. Rather, it is that the lifestyle of poor and dependent adults affronts most of the public. Above all, Americans expect able-bodied adults to work. But very few of them work consistently.

Skocpol thinks that social

programs have a power to confer respectability on their recipients if they are universal, rather than means-tested. Polls suggest, rather, that whether the recipients are seen as respectable determines whether the programs are. Social security is popular because the beneficiaries have work histories, not because it is universal. Welfare is unpopular mainly because most recipients lack such histories, not because it is targeted on the poor.

The only way to serve the poor better *and* get support is to turn many more poor and dependent adults into workers. Past policies to institute work incentives in welfare or provide public jobs to the poor tried to promote work effort. The trouble was the incentives had little effect on work levels, while public jobs did not cause most recipients to move on to available jobs in the private sector.

The only policy that has shown much effect is work requirements within welfare. That is, employable recipients have to be required to go to work, or at least enter education or training, as a condition of eligibility for assistance. Such stipulations are only now being implemented seriously. They raise income and employment levels among the recipients somewhat, but above all they sharply increase the proportion of dependents doing something to help themselves.

The Family Support Act of 1988 aims above all to expand work programs in welfare. If fully implemented, it has a chance to make work effort, rather than passivity, the norm among welfare adults for the first time. If it succeeds, welfare itself would become more respectable, and there would be no need for further universal programs, with all their attendant costs.

*Lawrence M. Mead,
New York University*

Do We Just Throw Out All the Targeted Programs?

■ Theda Skocpol appears to be saying that the *only* antipoverty programs that make sense are those that can be defined in universal terms. Here the perfect becomes the enemy of the good. There is an overtone, perhaps not intended—and if it is not, she should say so—that many if not most of the particular targeted program we have had, even those that are politically successful, like Head Start and WIC, are not worthwhile, or maybe even not desirable, policy.

If universal health care is, for example, the only acceptable approach to health coverage, then all of the Medicaid extensions of the past decade were either useless or downright mistaken, and future Medicaid expansions are equally misguided. I think we need a little more precision from Professor Skocpol, lest her cause be taken up by people less well disposed to the poor than she.

*Peter B. Edelman, Georgetown
University Law Center*

The States as Health Care Financing Laboratories

■ As Henry Aaron ("Looking Backward," summer issue) shows, obstacles to national health care reform are formidable. The reality of coming to grips with such challenges as skyrocketing costs, the conflicting positions of major players (Aaron's "high stakeholders"), and the increasing numbers of Americans who are un- or underinsured, to name but a few problems, leads me to believe that Aaron's timetable for action is far more realistic than what passes for conventional wisdom in the Washington of 1991.

Aaron fails, however, to take into account the numerous state initiatives designed to address shortcomings in U.S. health

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care financing and delivery. From Hawaii, with its 17-year near-universal coverage plan, to Oregon, with its much-scrutinized effort to curtail low-benefit care as a way of covering more individuals under medicaid, states are experimenting with a variety of approaches to expand access to care in cost-conscious ways. Such efforts are providing an important testing ground for much-needed national policies. These diverse state efforts may have a significant impact on the debate and thus influence the course of federal action. They should not be overlooked.

Bill Gradison,
U.S. House of Representatives

Judges and Legislators: Shall We Dance?

■ Robert Katzmann's "Building Bridges" (spring issue) properly emphasizes the need to view courts and legislatures in a continuum of institutions that interpret and act on the laws. Congress and the courts need to consider themselves partners in improving the quality of statutes.

All 50 states contend with the issues Katzmann identifies in the federal arena. In the wake of Judge Benjamin Cardozo's call in 1932 for improved relations between the legislature and the judiciary, states imaginatively created a wide variety of mechanisms to mediate between the legislative and judicial branches of government in regard to statutes. We have informally surveyed some of those efforts in our article, "Shall We Dance? Steps for Legislators and Judges in Statutory Interpretation" (*Minnesota Law Review*, forthcoming).

Many state legislatures have created oversight mechanisms—revisors of statutes, legislative staff positions, and research agencies—that monitor judicial opinions to detect

misinterpretations of statutes or respond when the court attempts to direct the legislature's attention to a particular statutory problem. Sometimes judicial opinions are distributed to committees or legislators who are interested in particular subject areas.

As one might expect, most states hinge their efforts to the traditional vehicle for judicial comment on statutes, the written judicial opinion. In this age of statutes, judges frequently interpret statutes and may identify anachronisms or problems in a statutory structure and use opinions to draw attention to or resolve a problem.

A few states have moved beyond relying on judicial opinions and have brought judges into the fray of studying and drafting legislation. New York, California, and Louisiana, for example, have created law revision commissions that include judges as well as members of the bar, legislature, law faculty, and the public to examine and recommend changes in statutes.

State legislatures and judiciaries have long struggled with many of the institutional, procedural, and ethical issues raised by legislators and judges working together to improve the quality of statutes. We believe that the successes and failures of these state efforts should be further explored to spur new efforts at both the state and federal levels to improve judicial-legislative relations.

Shirley S. Abrahamson,
Wisconsin Supreme Court, and
Robert L. Hughes,
Skadden Arps Fellow, Advocates for Children of New York

Sweeping Out the Ancien Régime

■ In your summer 1991 issue Charles Maechling ("Improving Our Criminal Justice System") seems somewhat bedazzled by the "2000-year tradition of the

civil or Roman law." By contrast, he appears appalled by our adversary system, the "judicial parody of the medieval tournament," and seems to lament that our Constitution and Bill of Rights may "raise insuperable barriers to change."

Maechling excoriates the Fifth Amendment and its somewhat expanded privilege against self-incrimination as an outgrowth of the British Star Chamber, and seems prepared to eliminate completely the hearsay rule and the admittedly controversial exclusionary rule under the Fourth Amendment. He has a low regard for our juries, and he is critical of cross-examination and indeed of the entire method of proof through the examination of witnesses. He also objects to plea bargaining, conspiracy charges, endless appeals, and our reliance on perjury against witnesses who lie.

By contrast, Maechling admires the European criminal justice system, with its three stages of police investigation, examination by the magistrate or *juge d'instruction* (the key phase), and then a trial at which stage the presumption of innocence is virtually reversed. He seems to prefer its professional judiciary, which is a civil service calling recruited directly from university graduates. He acknowledges the lack of *habeus corpus*, which fact permits pre-trial detention, and notes that because the focus is more on the criminal event than on the individual defendant, "the accused is to some extent the prisoner of the process."

To laud such a system even in 1991 when there is much justified discontent with our system seems, I would submit, unreal to the American legal or judicial ear. In fact, many countries of the civil law tradition, whether in Eastern Europe, Latin America, the Arab world, or Western Europe itself, are thinking of moving in our di-

rection, toward our jury system, our method of trial, our notion of due process. Even the French are thinking of eliminating the *juge d'instruction* and relying more on an American-style prosecutor.

What is it then that animates Maechling? Speaking of the co-existence of severe sentences and lenient sentences, he refers to the "simultaneous harshness and ineffectiveness of our system." But we are working on this through sentencing guidelines and the like. To be sure, both our civil and criminal litigation have led to excess, abuse, and absurdities. The media do play on these. Maybe it is this that leads Maechling to sound like Napoleon, and the revolutionaries before him, wishing to eliminate the *ancien régime*. Of course we are not about to do away with our media, let alone our Bill of Rights, nor indeed our legal profession. Moreover, the Supreme Court under Chief Justice Rehnquist is beginning, at the margin to be sure, to curb some abuses, for example the repeated use of *habeus corpus* in the federal courts to appeal state court decisions. It is also true that changes might be undertaken in our tendency to rely on lawyers rather than judges to steer a trial. We are beginning to see our judges become more assertive and, for example, order arbitration in civil cases to speed things up.

I share the view that we need changes in many aspects of our legal system, possibly even more in our civil adversary system than our criminal, but I suspect these changes will play out slowly and largely on their own. We will not have a revolution.

Don Wallace, Jr., Georgetown
University Law Center

The Review welcomes comments from its readers. Letters will be edited to conform to style and space.

Yes, Virginia, There Is a Peace Dividend

BY WILLIAM W. KAUFMANN

In 1981 President Reagan launched what was to become the fastest growth in the funding of national defense in American peacetime history. In 1985 Congress finally challenged the need for such munificence and began to vote for real decreases in a budget that had risen to \$376 billion in 1992 dollars. The result of their temerity was that budget authority for national defense fell nearly 22 percent by the end of fiscal year 1991. Because of the large balances of prior-year budget authority on the books, however, actual outlays continued to increase through 1989 and went down less than 4 percent in the next two years.

By coincidence, Mikhail Gorbachev advanced to the leadership of the Soviet Union in 1985. It is no exaggeration to say that, since then, he has played a critical role in bringing about the most dramatic changes in the map of Europe since World War II. Germany is united. Czechoslovakia, Hungary, and Poland have already replaced communism with democratic institutions and market economies. Bulgaria, Romania, and even Albania are searching for their own paths to freedom and prosperity. The Soviet Union is following the same course.

It now appears that the collapse of communism is irreversible. Moreover, Gorbachev has ended the Cold War and the military competition that accompanied it. He has withdrawn from Afghanistan and cooperated with the United States to resolve a number of regional conflicts. He has also signed unprecedented treaties to rid Europe and Asia of intermediate-range missiles, to make substantial cuts in the land-based non-nuclear forces of the Soviet Union, and to reduce strategic nuclear warheads by as much as a third.

It has been a virtuoso perfor-

mance. And its effects are likely to last. Indeed, recent events in the Soviet Union indicate that the collaboration will continue. Whether the U.S. defense budget can decline further than planned is an issue that now deserves the most serious consideration.

President Bush accepted the Budget Enforcement Act of October 1990 and has proposed to make real (inflation-adjusted) cuts in budget authority for national defense of 13 percent during the next five years. Active-duty military personnel would be reduced 16 percent under this plan, and outlays would fall 18 percent. These are, for the most part, reasonable interim goals, at least until democracy in the USSR is assured. However, the terms of the Budget Enforcement Act may require the Defense Department to lower its sights another 7 percent by 1996.

This means that defense budget authority (in 1992 dollars) would have to fall to \$232 billion in 1995 instead of the \$251 billion programmed by the Pentagon. Such a cut is quite feasible and can be made without any risk to U.S. security.

Defense planners have been pessimistic about the future for the past 45 years, and the Pentagon continues to be cautious as it attempts to peer into the 21st century. However, the dangers ahead are now smaller than the administration has assumed. Consequently, alternatives to the very conservative and expensive plans of the Pentagon do exist.

To cite one example, 57 percent of the U.S. defense budget is directly related to the deterrence of the Soviet Union. And if a major portion of the national intelligence and communications funds is allocated to the same objective, the total rises to more than 60 percent. Surely the Pentagon can reduce that share dramatically as a freer



Soviet Union becomes more transparent and Gorbachev and Yeltsin move to a market economy. Quite conceivably, an intermittent but powerful collective security system might emerge, as it did after Iraq invaded Kuwait. Under those conditions, a number of uncertainties could be reduced, and as much as 39 percent of the 1992 defense budget authority (in real terms) could cumulatively be allocated to other uses during the following ten years.

A stable and democratic Soviet Union willing to work in close collaboration with the United States and its allies could also lead to a more ambitious system of cooperative security. Under such a system, rules of international behavior would be established; military capabilities would be strictly defined and limited by all parties; and this new world order would be upheld by the United Nations Security Council or a comparable mechanism. This alternative, which would

accord with the best interests of the major powers, could produce a dramatic decrease in uncertainty. It could also cut U.S. defense budget authority by 47 percent.

Secretary of Defense Richard B. Cheney has remarked that peace will be the real peace dividend. True enough, but that need not preclude a windfall that cumulatively could amount to \$300 billion or more in 1992 dollars during the next 10 years. Much depends on how profligate an investment Mr. Cheney makes to obtain his dividend. ■

William W. Kaufmann, a non-resident senior fellow in the Brookings Foreign Policy Studies program, is professor emeritus at MIT.

He is the author, with John D. Steinbruner, of Decisions for Defense (Brookings, forthcoming).



Who's In Charge Here?

How Changes in Corporate Finance Are
Shaping Corporate Governance

The decade of the 1980s was notorious for financial excesses in the corporate sector. Especially during the latter half of the decade, financial markets appeared willing to provide funds for almost any kind of takeover or refinancing plan, regardless of who the parties were, whether management approved, or how much debt would be incurred. The attention lavished by the news media on the spending spree is understandable. Certainly much of that frenetic activity was ill directed; it left many firms incapacitated by debt. But lambasting the decade for its excesses alone ignores what may actually be a more complex legacy of the corporate takeover and refinancing movement: a shift in the power structure of corporate governance away from traditional corporate management toward the financial markets.

Understandably, recession and corporate failures have so far dominated the “morning after” feelings about the 1980s. But corporate debt burdens—a national preoccupation of late—have already begun to ease as excessively indebted firms have failed and others have returned to issuing stock rather than borrowing to finance investments (see sidebar on page 11).

The shift in attitudes toward leverage has been rapid. Less than two years ago, academic articles and the business press were glorifying the power of debt to impose discipline on corporate managers by forcing them to hold down new spending and squeeze better performance out of existing assets. With the shakeout now under way, and debt levels being reduced to more manageable levels, it would be easy to dismiss the whole takeover and financial restructuring movement of the 1980s and its attendant academic cheerleading as little more than the mad frenzy of an unfettered market.

The problem is that many of the economic developments that fueled the movement—in particular, its emphasis on debt-driven refinancing—are still with us. The costs of capital are still high, competitive pressures are still fierce, and returns on new investment in many industries are still low. Despite the scramble to undo the excesses of the 1980s, leverage ratios will probably not soon return to their pre-1980s level, nor can corporate executives relax, assured that they will no longer be threatened by takeover or other interference from financial markets. The corporate restructuring movement, though short-sighted in many endeavors, brought several real changes in corporate governance.

First, shareholders in general and institutional investors in particular have gained considerable economic and political power in relation both to corporate management and to other stakeholders when it comes to decisions about who should run the corporation. Their political power is not yet secure—in fact, the state courts and state legislatures, where most corporate law is made, have handed more significant victories to management in the past few years than to shareholders’ groups. Twenty-four states now have anti-takeover laws that restrict the rights of a company making a tender offer to vote the shares it holds once

its holdings reach a specified percentage of the target company’s shares. Twenty-eight states have laws that specifically permit managers of target firms to consider the interests of constituents other than shareholders—employees, for example, or even suppliers or communities—in deciding whether to approve a takeover proposal. But the economic power of shareholders and institutional investors is growing each year, and corporate executives can no longer expect these classes of investors to remain passive.

Second, stockholders, dealmakers, banks, and corporate executives are all learning that financial instruments can be effective tools for exercising control over corporate management. Although the influence of the capital structure (the total combination of various debt and equity instruments that provide capital for the firm) on the value of the firm is complex and far from fully understood, it is clear that financial instruments like debt that have strict payment schedules and covenants provide a different set of pressures and incentives for management than instruments like equity that have optional dividends. Different classes of financial instruments can also give investors different ways to try to control the disposition of corporate resources. The significance of both these changes will become more important in the years ahead.

Corporate Managers under the Gun

Among the many constituencies that participate in the wealth-generating activities of a corporation, the question of whose claims should have priority, and who should have control over decisionmaking, remains unresolved. The corporate restructuring movement, and especially the success of corporate takeover specialists during its early phases, made it clear that management and boards of directors, even of large corporations, were vulnerable. They could be pressured by raiders, shareholder groups, and institutional investors into altering strategies, increasing the payout of cash flows (usually by buying back stock and committing future cash flows to paying off the debt incurred in the process), and even making major personnel changes.

Although takeover activity has slowed, at least for now, shareholder activism has not. One indication is the number of proxy contests, in which outsiders challenge governance proposals put forth by management by actively soliciting shareholder votes for competing proposals. From 1981 through 1985, the number of proxy contests averaged 27 a year. During the second half of the 1980s, the number of proxy fights per year averaged almost 43. While proxy activity has not continued to increase, it appears to have stabilized at this higher level. Institutions and organized shareholder activist groups are also moving to submit their own proposals in proxy materials, and have pressured a number of firms, including K Mart, Avon, Sears, Boise Cascade, and Time Warner, to change their bylaws and operating procedures in ways that reduce takeover defenses or broaden shareholder rights and shareholder participation in corporate governance.

Why are investors so eager to look over the shoulders of corporate management? Before the 1980s, executives of large corporations in this country were re-

**Margaret
M. Blair**

Margaret M. Blair, a research associate in the Brookings Economic Studies program, is currently at work on Takeovers, LBOs, and Changing Corporate Forms.

markably free to run their companies without significant interference from investors. For several reasons corporate governance was simply not significantly linked to corporate finance. First, the common stock of most companies was fairly widely held by individual investors, few of whom controlled enough stock to wield much power. And second, major financial institutions in this country, unlike those in Japan, Germany, or other competitor nations, have been precluded from exercising strong control over corporations by a variety of laws and institutional arrangements designed to prevent or inhibit concentration of financial power and limit the exposure of financial institutions to business risk.

According to Mark Roe, of Columbia University Law School, "Banks, insurance companies, mutual funds, and pension funds are either prohibited from taking control blocks (in corporations), regulated so that taking control blocks would be costly, or structured so that operating company managers control their decision-making. And securities rules raise the cost of coordination among fragmented investors." The Glass-Steagall Act of 1933 prohibited banks from owning stock or affiliating with investment banks that do. The Bank Holding Company Act of 1956 restricts bank holding companies from owning control blocks in companies not closely related to banking. Potential liability under trustee laws encourages bank trust departments to fragment their holdings, and other rules make it difficult or impossible for the bank trust department to act in concert with other institutional stockholders.

Also in the 1930s, the Securities and Exchange Commission moved to discourage mutual funds from taking large positions in individual companies by imposing tax and regulatory restrictions on funds that own 10 percent or more of the stock of any company. Life insurance companies are similarly restricted, with 40 states imposing limits (ranging from 2 percent to 25 percent) on the proportion of insurance company portfolios that can be invested in common stocks. The insurers are also usually prohibited from taking large equity positions in any one company. Pension funds are not subject to the severe portfolio restraints that other institutions are, but fiduciary rules encourage portfolio fragmentation.

No More Carnegies, No More Mellons

The earliest large corporations tended to be controlled by the magnates who created them—Andrew Carnegie, Andrew Mellon, John D. Rockefeller, J. P. Morgan. But by the end of the 1930s, control of most corporations had passed into the hands of professional managers who, like all other stockholders, held relatively small proportions of the total outstanding stock.

The potential problem with such an ownership structure—the separation of ownership from control—was noted as early as 1932, by Adolf Berle and Gardiner Means in *The Modern Corporation and Private Property*. Discussion of the problem, at an academic level, recurred in the 1960s when William Baumol, Robin Marris, Oliver Williamson, and other economists were developing "managerialist" theories of the

firm. These theorists noted that a manager who is not also a major stockholder of a firm tends to manage the firm in ways that serve his own best interests, even at the expense of the best interests of the owners—that is, the stockholders. The widely traded corporation does not have a clear mechanism that makes managers accountable to shareholders or that ensures that the incentives of managers are aligned with those of shareholders.

Paradoxically, for 45 years after Berle and Means had first pointed out the problem, individual and institutional shareholders—who would seem to have the most to worry about—paid little attention. One reason, of course, was that their control was fragmented and would have been difficult to exercise under any circumstances. But more important, as a group, stockholders in U.S. corporations were doing remarkably well. An investment made in a portfolio matching the Standard & Poor's 500 in 1942 would have nearly quadrupled in value (adjusted for inflation) by 1972, even while paying out yearly dividends of 3–6 percent of the (growing) market value of the portfolio.

Many other beneficiaries of the wealth-producing capacity of the corporate sector were also doing quite well. During the same period, average hourly earnings of workers and total corporate income tax payments doubled in real terms. Corporations in general, and the manufacturing sector in particular, were extraordinarily productive, with total factor productivity in manufacturing growing an average of around 2 percent a year. The system of governance of U.S. corporations, it seemed, was working very well and was rewarding all participants generously.

The turning point came in the 1970s, when productivity collapsed, wage growth slowed dramatically, and the stock market sank into the doldrums. An investment made in the S&P 500 in 1972 had actually declined in value by 1979 even before taking inflation into account, and had provided a dividend of only 3–5 percent in the meantime. Given the inflation rates of the 1970s, real yield in most years was negative. The manufacturing sector entered the 1980s with gross returns to capital lower than they had been at any time in the postwar period. Then, to compound the problem, real (inflation-adjusted) interest rates shot up between 1979 and 1982 to levels two and three times higher than had been seen at any time during the previous 30 years. High interest rates meant that investors could earn higher rates of return on safe securities such as government bonds than on many corporate stocks. In short, stockholders were taking a beating. The stage was set for innovative financiers and brash takeover artists, feeding on the dissatisfaction of individual and institutional shareholders, to begin wresting control of corporations from traditional managements.

Down in the Oil Patch

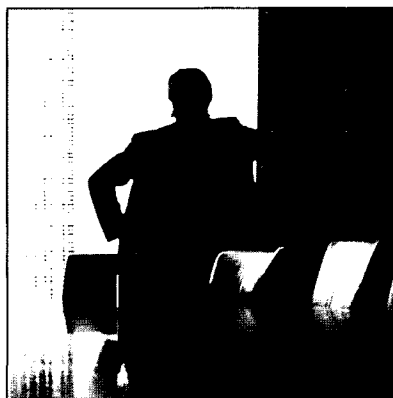
One of the industries where the divergence first became acute between management choices that suited managers and choices that provided the highest return for shareholders was the oil industry. The huge surge in revenues from the oil price increases of the 1970s encouraged oil company managements to invest vast

sums in coal, synthetic fuels, copper, and even in electric motors, computers, and department stores. These investments built big empires for oil company managers, but provided little or no return to shareholders. Not surprisingly, then, one of the earliest of the new breed of takeover artists to begin shaking up corporate boardrooms came from the oil industry. T. Boone Pickens, Jr., began in 1979 by transforming the structure of his own company, then called Mesa Petroleum Inc., by spinning off assets into several "royalty trusts," units of which were distributed to Mesa shareholders as an extraordinary dividend. Through the trusts, the firm was able to pay out a large part of its earnings directly to its "beneficiaries" (the shareholders) without having those earnings taxed first as corporate income. Pickens told members of the financial press at the time that he didn't think he could find enough new oil cheaply enough to justify retaining Mesa's earnings and reinvesting them in oil exploration, so he devised a way to pay out those earnings without having them taxed twice. The value of Mesa stock rose from \$54 at the time the royalty trust plan was announced to \$86 four months later when shareholders voted to approve the plan. Within a few months after the plan had been implemented, the combined value of Mesa stock and Mesa Royalty Trust shares reached \$112.

Pickens, convinced that the same logic applied to "big oil" as well, went on a crusade to persuade the management of the large oil companies to slash their investment programs and increase their payouts. Not surprisingly, he was regarded by mainstream oil company executives as little more than a renegade. The financial markets, however, took notice. By 1981, Pickens had lined up enough backing from individuals and financial institutions such as Credit Suisse and Continental Illinois National Bank to make a takeover bid for Cities Service. Gulf Oil beat out Mesa's bid and won control of Cities Service, but Mesa's profits on the transactions just made it hungrier for more deals. Mesa later made a bid for General American Oil (which was, instead, acquired by Phillips Petroleum), and then Pickens really shook up the industry when Mesa led an investor group in making a run at Gulf, a company nine times the size of Mesa. The effort pushed Gulf into the arms of Chevron (then called Standard Oil of California). Later, through a different investment vehicle, Pickens tried to acquire, and ended up forcing complete financial restructurings of, both Phillips Petroleum and Unocal. These forced restructurings had the exact effect on management strategy that he had recommended for the oil industry: the companies bought back large blocks of their own stock, which forced them to slash spending and scale back their investment programs while they paid out their cash flow in the form of pretax interest payments on the debt they incurred to buy the stock.

Mesa was accumulating a growing war chest from the profits on each of its takeover attempts. But what enabled it to pursue these vastly larger targets was, first, the willingness of numerous institutions and large individual investors to pledge in advance to buy the "junk" bonds or other high-risk, high-yield securities Mesa needed to float to do a deal and, second, the

Is the Debt Binge Over?



The freewheeling use of debt pushed the average ratio of credit market debt to net worth (at book value) of firms in the nonfinancial corporate sector from 30.5 percent in 1980 to 56.2 percent by 1990, an all-time high. At the peak of the takeover and debt-financing frenzy in the mid-to late 1980s, firm failure rates

reached levels unseen since the Depression, and while they have come down a bit in the past two years, the failure rate in 1990 was more than double the average rate for the 1970s, and half again as high as in the 1960s.

Managers of highly leveraged companies such as Pan Am (which is currently in Chapter 11 bankruptcy proceedings), R. H. Macy, Black & Decker, and Bally Manufacturing have been forced to sell off assets, sometimes at fire-sale prices, to make the interest payments on their debt. Southland Corp., Interco, and numerous others have put together offers to try to swap their high-yield junk bonds for combinations of equity and lower-yielding debt. After backing down from an earlier, less acceptable scheme, Time Warner persuaded its shareholders to put up \$2.8 billion in additional equity so that the company could pay off some of its debt.

As a result of deals like these, the pressure on many highly leveraged corporations is being rapidly relieved. From 1984 to 1989 U.S. companies withdrew existing stock from the market (borrowing the money needed to buy it back) at a far faster rate than they offered new stock—so that the aggregate measure of new equity issues was actually negative in every one of those years. All told, more than \$500 billion worth of corporate equity was withdrawn from public markets during those six years. But during 1990 small, start-up companies began coming back into the market to make "initial public offerings" of equity, and larger, older companies began selling new stock again to raise money for investment or to pay off old debts—turning the new equity issue measure strongly positive by the first half of 1991. In April, *Business Week* estimated that new equity offerings could total \$70 billion this year.

In good times, with markets growing, capital cheap, and competition limited, almost any governance system can seem to work well. The test comes when markets are flat or shrinking, capital costs are high, and competition is tough.

willingness of institutional investors with large holdings in the target companies to sell out to Mesa in the case of a bid.

The upshot was that a “raider,” an ambitious outsider with some serious ideas about how corporate assets should be redeployed, had gained remarkable power and influence within one industry by making creative use of new financial instruments and garnering the support of investors who controlled sizable amounts of institutional money. The lesson was not lost on other raiders or on other institutional investors. Over the course of the 1980s, insurance companies, savings and loans, mutual funds, and, to some extent, pension funds placed large amounts of money at the disposal of raiders, acquisition-minded corporations, and leveraged buyout management firms, because, at least for a while, these refinancing gambits appeared to be earning higher returns than ordinary long-term investments in the corporate sector. Debt, particularly high-yield, high-risk securities previously shunned by the financial community, became an important weapon in their arsenal. For the most part, institutions continued to be passive investors, but the aggregate resources they controlled gave raiders a very big stick and tilted the balance of power in the “market for corporate control.” No longer could top management, even of very large corporations, operate with impunity.

To be sure, management fought back. Roe argues that much of the legal history of the battles for corporate control in the 1980s can be interpreted as management trying to win back in the political arena, especially in the state legislatures, the autonomy and protection from takeover threats that they were losing in the financial markets and in court decisions and regulatory rulings. Forty states now have some sort of anti-takeover law.

The Academic Theorists Get into the Act

Alongside these developments, academics in the finance departments of business schools began to look seriously at the problem of separation of ownership and control and to link questions of corporate governance to financial structure. Previously, finance theory had argued that, apart from taxes and potential bankruptcy costs, the value of a firm should be independent of the firm’s capital structure. In a paper published in 1976, Michael C. Jensen and William H. Meckling first began theorizing about how the capital structure of a firm determines the degree to which managers have the discretion or the incentive to misuse corporate resources, and why that would influence the firm’s value.

A flurry of theoretical and empirical work by finance scholars followed in the early 1980s. Its central thesis was that the takeover market provided great benefits to the economy by keeping the pressure on corporate managers to maximize share values. Some analysts further argued that the best combination of managerial incentives and external monitoring occurred in highly leveraged companies, in which the reduced equity base of the firms is concentrated in very few hands, those of managers themselves and a few outside investors who can closely monitor the

performance of the managers. The argument provided academic rationale and respectability for leveraged buyouts as a revolutionary new corporate form. In the fall of 1989, Jensen published a controversial article in the *Harvard Business Review* declaring that "the publicly held corporation has outlived its usefulness in many sectors of the economy and is being eclipsed" by organizations that "use public or private debt, rather than public equity, as their major source of capital."

The declaration was, at best, premature. Leveraged restructurings have not and probably will not solve the problem of developing effective corporate governance structures. Among the things we have learned from the 1980s is that not all business situations are amenable to the use of debt finance.

Many of the leveraged buyouts of the early part of the decade did indeed improve firm performance on many fronts. Typically, the firms involved were small (the vast majority were business units or divisions being divested from larger corporations) and were in industries that do not do much research and development and that did not need large investments. Investment rates typically fell in the first few years after an LBO, but cash flows increased. At least some of the increased cash flow came from tighter management of inventories, payables, and receivables. Many of these early LBOs went public again a few years after the leveraged buyout, with sales of stock that netted huge profits to the investors that had done the original deal.

By contrast, leveraged buyouts done after 1985 and junk bonds issued after that date were generally of much lower quality. While there have been individual successes, their collective performance has been disappointing. By the middle of the decade, deals were being done at a much faster pace, and many involved much larger companies. Later in the decade, target firms were less likely to be concentrated in industries with stable cash flows and low investment needs, and the debt instruments used to restructure the firms were more likely to include deferred payment schedules, payment "in kind" clauses, and other innovative devices that enabled the firm to postpone the day of reckoning on its borrowing. The financial analysis used to justify these restructurings appeared to rely much more heavily on highly speculative cash flow forecasts, and, at the same time, the securities had less immediate disciplining effect.

Debt Is No Panacea

The success of the early deals suggests that high levels of debt, used selectively, can be part of a financial restructuring program that improves the accountability and performance of some firms in some industries. But widespread failure of the later deals makes clear that debt will not solve the corporate governance problem for all companies. Moreover, used injudiciously, high leverage can wreak havoc.

It seems abundantly clear that firms need flexibility and financial strength to respond quickly and aggressively to good investment opportunities and to ride out temporary hard times. The essence of the problem of corporate governance is to devise systems of finance and control that provide all this, while at the same

time ensuring that corporate management is encouraged to use the company's resources efficiently and is accountable for its performance.

In good times, with markets growing, capital cheap, and competition limited, almost any governance system can seem to work well. The test comes when markets are flat or shrinking, capital costs are high, and competition is tough. Many firms, in many industries, are likely to face those adverse operating conditions over the next few decades. The controversy over corporate control is sure to continue in the 1990s.

But this time around, institutional investors will no longer be passive. Institutions now account for 43.5 percent of the funds invested in corporate equities, up from 33 percent in 1980 and 31 percent in 1970. This share, especially the portion of it represented by pension funds, is expected to continue growing well into the 21st century, at least until the baby boom generation retires and starts drawing down its pensions. Managers of these funds increasingly recognize that the sheer size of the funds discourages management from simply buying and selling their holdings in companies to express their confidence or disapproval. They must view themselves as long-term investors and begin to share responsibility for the long-term performance of the companies in which they invest.

Sharing responsibility will mean sharing control, however, and institutional investors are already moving to wield their big stick. In April of 1990, for example, Pennsylvania passed a strict anti-takeover law that changed fiduciary standards to allow directors to place other interests above shareholder interests, restricted voting rights of certain large shareholders, and forced "disgorgement" of the profits of short-term holders who sell after an attempt to control the company. But, partly in response to a barrage of letters to corporate directors from the heads of large pension funds, one in every five of the large corporations headquartered in Pennsylvania chose the option offered under the law not to be governed by these provisions.

Last June the staff of the Securities and Exchange Commission proposed a rule change that would permit shareholders to vote on procedures for setting executive compensation. Such a step would represent a significant victory for shareholder activist groups, many of which are led by big institutions, since executive compensation has always been considered a matter to be left solely to the discretion of directors.

For policymakers in the regulatory bodies and state legislatures where the rules of play will be determined, it will be extremely important to understand some of the complex issues underlying these debates over governance. They are not just a power struggle between fund managers and corporate managers, although they are partly that. More important, these debates are about finding institutional structures that address the problem of corporate governance first raised in the 1930s. Corporate managers (usually) are playing with other people's money. To whom must they be accountable, and how do we make them accountable without undercutting their efforts to innovate, take risks, and compete? ■

Will Quebec Secede?

Why Quebec Nationalism Is So Strong

Last June Quebec's National Assembly enacted legislation authorizing a provincial referendum in the spring or autumn of 1992 on the constitutional future of the province. The issue for Quebec voters may be whether to remain federated with Canada or to secede and become a sovereign nation. If voters choose secession, they will be taking an unprecedented step in splitting a modern welfare state. How are we to explain a secessionist movement so strong as to threaten seriously the unity of a wealthy modern state, a liberal democracy ranked among the world's most agreeable places to live?

Like all secessionist movements, Quebec's grows out of two antithetical feelings: fear and confidence. The fear of being weakened, or even disappearing, if it stays in the union; the confidence that it can perform as well, or even better, on its own. To these two conflicting feelings, one must add, in the case of Quebec, a feeling of rejection, the sensation of no longer being welcome in the union.

Quebec's fear is rooted in its linguistic heritage and is longstanding. As a French-speaking province in an overwhelmingly English-speaking country on an even more overwhelmingly English-speaking continent, Quebec has a very real concern about losing its linguistic identity. Throughout its history, Quebec has been haunted by the experience of Louisiana and

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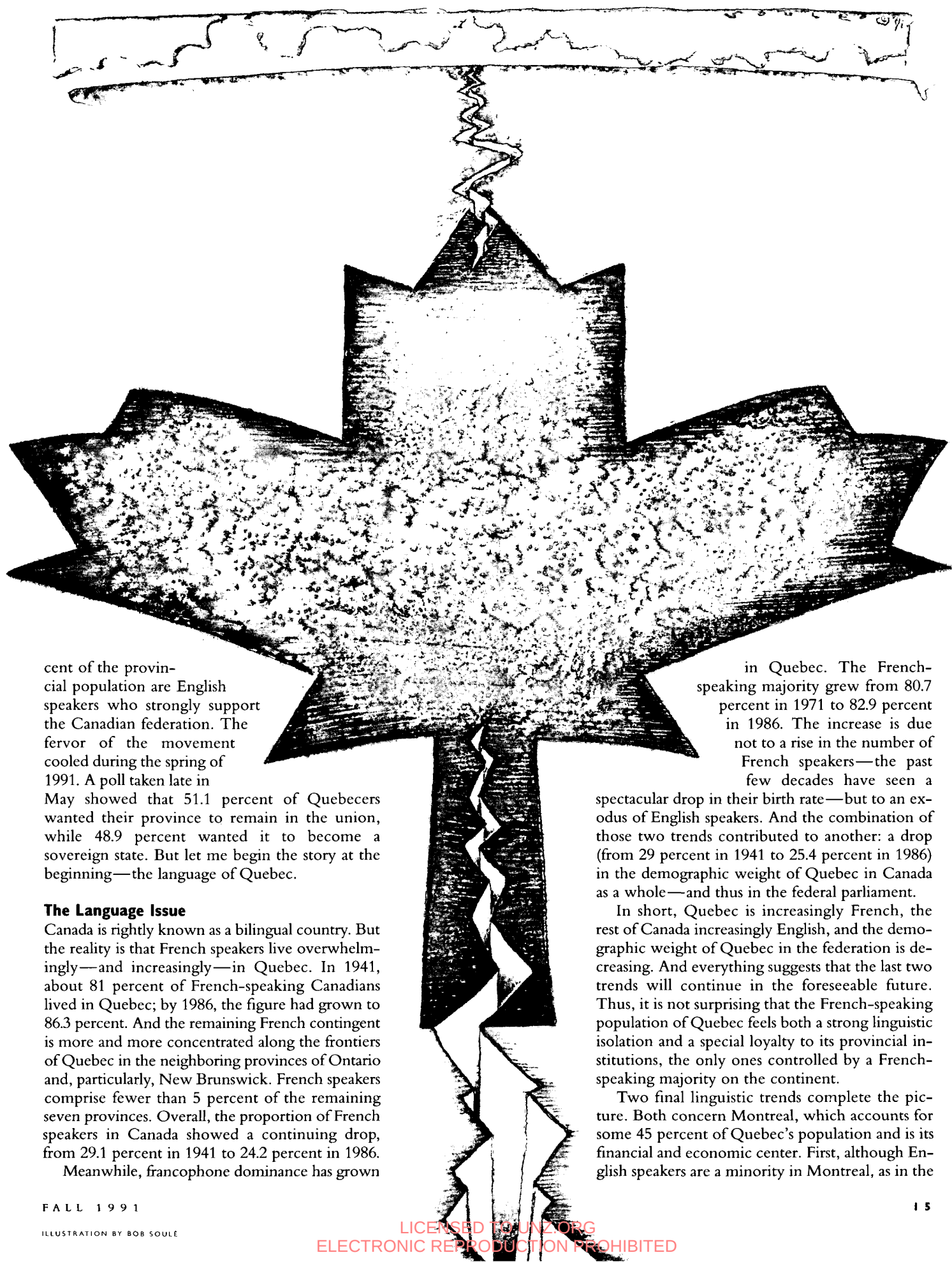
This article is adapted from a chapter in The Collapse of Canada?, edited by Kent Weaver (Brookings, forthcoming).

other parts of Canada, where the French origins live on only in folklore.

Quebec's confidence is relatively newly won. As a Canadian province, it boasts one of the industrialized world's strongest subnational governments, a government that has taken on increasingly wide-ranging responsibilities. That confidence, along with recent economic gains, strengthens the opinion that it can perform perfectly well on its own.

The feeling of rejection can be pinpointed precisely. It springs from the 1987 crisis known as Meech Lake. The failure of Canada's ten provincial legislatures and its federal parliament to ratify an accord recognizing Quebec as a distinct society within Canada was perceived as an unprecedented blow by French Quebec. Quebec's fears about preserving its linguistic identity and its confidence in its ability to perform on its own were not enough to trigger secession sentiment. Meech Lake was what did it.

Fear, confidence, and rejection. I will review successively the strength of these three feelings in contemporary Quebec. I must say at the outset that I do not think that they are strong enough to cause the first modern welfare state collapse in history. But I may be wrong. Although support for full sovereignty never reached 50 percent before 1990, it peaked at 70 percent in some polls during the second half of 1990—an exceptionally high margin, given that about 18 per-



cent of the provincial population are English speakers who strongly support the Canadian federation. The fervor of the movement cooled during the spring of 1991. A poll taken late in May showed that 51.1 percent of Quebecers wanted their province to remain in the union, while 48.9 percent wanted it to become a sovereign state. But let me begin the story at the beginning—the language of Quebec.

The Language Issue

Canada is rightly known as a bilingual country. But the reality is that French speakers live overwhelmingly—and increasingly—in Quebec. In 1941, about 81 percent of French-speaking Canadians lived in Quebec; by 1986, the figure had grown to 86.3 percent. And the remaining French contingent is more and more concentrated along the frontiers of Quebec in the neighboring provinces of Ontario and, particularly, New Brunswick. French speakers comprise fewer than 5 percent of the remaining seven provinces. Overall, the proportion of French speakers in Canada showed a continuing drop, from 29.1 percent in 1941 to 24.2 percent in 1986.

Meanwhile, francophone dominance has grown

in Quebec. The French-speaking majority grew from 80.7 percent in 1971 to 82.9 percent in 1986. The increase is due not to a rise in the number of French speakers—the past few decades have seen a

spectacular drop in their birth rate—but to an exodus of English speakers. And the combination of those two trends contributed to another: a drop (from 29 percent in 1941 to 25.4 percent in 1986) in the demographic weight of Quebec in Canada as a whole—and thus in the federal parliament.

In short, Quebec is increasingly French, the rest of Canada increasingly English, and the demographic weight of Quebec in the federation is decreasing. And everything suggests that the last two trends will continue in the foreseeable future. Thus, it is not surprising that the French-speaking population of Quebec feels both a strong linguistic isolation and a special loyalty to its provincial institutions, the only ones controlled by a French-speaking majority on the continent.

Two final linguistic trends complete the picture. Both concern Montreal, which accounts for some 45 percent of Quebec's population and is its financial and economic center. First, although English speakers are a minority in Montreal, as in the

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rest of Quebec, they are increasingly concentrated there (three of every four English speakers in Quebec live in Montreal). Until recently, they were also in control of the corporate and financial sectors, and English was the language of business in the province.

Montreal is also home to the vast majority of immigrants to Quebec, a group that is growing in demographic importance. The proportion of “allophones”—those who have neither French nor English as a mother tongue—in Quebec increased from 3.7 percent to 6.8 percent between 1951 and 1986. By 1974, 88.6 percent of Montreal’s allophone children received their instruction in English. The situation was serious enough to make French speakers begin to fear losing control of their metropolis. And if Montreal became English, the rest of Quebec would no longer be in a position to shape a strong French community.

Language and Politics

Since the 1960s, language has been at the root of every nationalistic outburst in Quebec. Toward the end of the 1960s, conflicts over the control of the language of instruction in some towns in the Montreal area contributed to the creation of the *Parti québécois*, the political party in Quebec dedicated to provincial sovereignty. The issue continued to simmer until 1976, when the *Parti québécois* won its first majority of seats in the Quebec National Assembly.

Nine months later, the new government passed a new language law, Bill 101, which stipulated that French must be the usual language of work, instruction, communication, trade, and business in Quebec. The English-speaking minority could retain all its healthcare and social institutions, its schools and universities in its own language, but access to English elementary and secondary schools was no longer to be available to French speakers and allophones.

Despite protests from many factions, the bill was implemented. Its success in defending the French language in Quebec quickly became clear—so clear that it helped defuse the secessionist sentiment. In May of 1980 the *Parti québécois* held a referendum in which it asked Quebecers to confer on it the authority to negotiate with the federal government a new status for Quebec. The party had in mind something it called “sovereignty-association,” a combination of political sovereignty and economic association along the lines of a common market. But the referendum failed: no more than 40 percent of Quebecers were willing to grant the party the authority it requested.

The *Parti québécois* government had discovered the way to protect the French language within the Canadian federation. Knowledge of French grew from 36.7 percent to 53.7 percent between 1971 and 1986 among the English population of Quebec, and from 47.1 percent to 66.3 percent among the allophones. The proportion of students at the pre-elementary, elementary, and secondary levels studying in French schools reached 90.2 percent in 1990 among the whole population of Quebec, and increased from 38.7 percent to 72.7 percent among the allophones between 1980 and 1989. The resultant feeling of lin-

guistic security remained strong during the years following the referendum and—along with an economic recession and the demoralization left in the wake of the referendum defeat—kept secessionist support low.

The linguistic question was not an issue at all during the 1985 provincial campaign, and it was possible to assume at that time that a durable consensus had been reached on the matter. Linguistic peace prevailed. But on December 15, 1988, the Supreme Court of Canada set off another crisis by ruling unconstitutional a provision in Bill 101 that required the exclusive use of French on commercial signs in Quebec. According to the court, Quebec could require the use of French on signs, but it could not prohibit the use of other languages.

The complexity of francophone public opinion regarding the language issue is clear from the public reaction to the court's ruling. Support for Bill 101, taken as a symbol of the will to protect the French reality in Quebec, was strong even though support for the specific compulsory measures of the law was much lower. Polls usually showed an absolute majority contradicting itself, opposing any changes in Bill 101 while supporting bilingual policies. The prescriptions to banish other languages in so many areas of public life were never popular except among the core group of nationalists. For them a unilingual French signs policy was an important issue, especially in Montreal, because a "French face" in the street is one way to signify to everybody, in particular the new immigrants, that things happen in French in Quebec. And even though they are a minority, the supporters of the "French only" policy are able to mobilize public opinion by arousing the feeling of linguistic insecurity among the whole French-speaking population.

The Inside-Outside Bill

On December 23, 1988, a new law, Bill 178, was passed legalizing the use of languages other than French for commercial signs inside (but not outside) commercial buildings as long as they are in smaller letters than the French. The so-called inside-outside bill had a decisively negative effect on English-speaking opinion in Quebec and elsewhere in Canada and is surely one cause of the widening disenchantment with the Meech Lake Accord in English Canada and of its ultimate failure in June 1990. Bill 178 also failed to stop the new nationalist fervor in Quebec.

The environment created by the Supreme Court decision and Bill 178 made possible a number of political developments. One was the biggest series of nationalist meetings and demonstrations held since the 1980 referendum. Another was the resignation of the moderate leader of the *Parti québécois*, Pierre-Marc Johnson, in favor of the sovereigntist Jacques Parizeau. Yet another was a significant gain in popularity for the sovereigntist idea in public opinion polls.

The Supreme Court ruling was not the first attack by a federal institution on a piece of the Quebec government's language policy. In fact, language and nationalist issues are connected in Quebec in part be-

cause the policies of the federal and provincial governments contradict in some ways. The 1969 Official Languages Act was passed by the federal parliament, with the support of all parties, to implement official bilingualism in federal institutions. The law was followed in 1974 by regulations on bilingual packaging and labeling. The aim was to guarantee access to basic services in both French and English from coast to coast. Although this federal policy had some positive achievements regarding the presence of French in the federal institutions and the learning of French in the English-speaking population, it did not make the English-speaking provinces effectively bilingual, and it did not stop the assimilation of French-speaking communities outside Quebec. Nor did the federal policy respond to the aspiration of the French-speaking population in Quebec (in Montreal in particular), which is to live daily life in French, to work, conduct business, buy goods, and go to the theater, all in French, and to secure the same French environment for future generations. Bilingualism in federal institutions is perceived positively by Quebec francophones, but it by no means ensures being understood in French in all areas of Montreal, nor does it help to attract immigrant populations to the French community.

The Canadian federal government defines its role as the protector of linguistic minorities throughout the country. It considers its role in a strictly symmetrical manner, that is, that both minorities, the French outside Quebec and the English inside Quebec, must receive protection. Federal policy has been to institutionalize the symmetry of the two languages instead of protecting the sole endangered language, French. During the 1970s and 1980s federal language policy unintentionally aided Quebec nationalism by challenging the Quebec government's efforts to protect French in Quebec. As a result, the Quebec government has been increasingly perceived by francophone Quebecers as the collective protector for French speakers, while the federal government became a kind of intruder state. More and more, Quebec's French speakers began to feel that their interest was best served by a stronger provincial government facing the federal government.

Increased Confidence in Quebec

Always concerned about their prospects for survival in the Canadian federation, French Quebecers enjoyed a growing confidence in their own abilities over the 1970s and 1980s.

The first source of pride was the dramatic improvement in their economic status relative to the English-speaking population. The gap between the average total income of English-speaking and French-speaking Quebecers decreased from 44.7 percent in 1970 to 16.3 percent in 1980, a bilingual French speaker getting even more than a bilingual or unilingual English speaker at the end of the period. The proportion of workers employed by francophone-owned enterprises increased from 47.1 percent in 1961 to 61.6 percent in 1987. French speakers comprised only 30.5 percent of managers of enterprises operating in Quebec in 1959, but 50.8 percent in

1988. Moreover, French-speaking mega-enterprises grew up, some of their presidents becoming well-known figures.

Many Canadians had believed that Quebec nationalist sentiment would diminish with modernization and the economic advancement of the French-speaking population. They were convinced that the emphasis placed by radical nationalists on the economic alienation and exploitation of the *Québécois* in the Canadian federation would gradually offer less and less appeal as French speakers made economic strides.

Instead, the economic gains have contributed to a growing confidence that may, ironically, lead to secession. Economists who favor sovereignty for Quebec argue that the shift to sovereignty would be quiet and not costly and that the long-term result would be an overall improvement. A poll published on May 12, 1990, showed that 48.5 percent of the chief executives of 200 of Quebec's 500 largest enterprises thought that independence would have a positive effect in the long run. Only 13.3 percent foresaw a negative effect.

Such optimism contrasts starkly with the hostility to the secessionist idea expressed by the business class in Quebec around the time of the 1980 referendum. Opponents of sovereignty at that time argued that it would cause big business and foreign capital to flee Quebec. Today a widely shared conviction is that the new capitalist spirit in the province will inspire confidence and credibility in international investors and that the local business class is solid enough to support the transition costs. Some important businessmen have attracted considerable attention by saying so.

Quebec Government, *Oui*— Federal Government, *Non*

A second source of confidence for French speakers has been the development of the Quebec government into a modern quasi state, with exclusive or joint responsibility with the federal government over education, health, welfare, natural resources, municipal affairs, housing, culture, energy, immigration, industry, language, communication, and so on.

Quebec nationalists now point out that the move toward political sovereignty would be easy because provincial institutions have been expanded in all directions. And, indeed, Quebec already has modern governmental bureaucracies, a complete educational system through the university level, public hospitals and social welfare organizations, its own financial institutions, public enterprises, and a network of municipalities regulated by the provincial government. More than any other Canadian provincial government, Quebec has involved itself in diplomacy, immigration policy, and autonomous fiscal policy. It is the only province to operate a full pension plan for its residents separate from the federal one that operates in the other provinces. A growing contingent of many hundreds of thousands of public servants, teachers, and various intellectuals has become the main basis of nationalist supporters. In fact, Quebec's provincial government is already the most powerful second level of government of all OECD countries. By contrast, the Canadian federal government is the weakest cen-

tral government of all OECD countries in terms of autonomous fiscal capacity in comparison with the second level of government.

Since the beginning of 1990 French Quebec has grown increasingly critical of the federal government. "Canada does not work anymore" is an often-heard slogan. The current Conservative government in Ottawa inadvertently stirred Quebec nationalist sentiment through its determination to combat huge budget deficits (more than 60 percent of gross domestic product in 1989–90). As a consequence of reductions in federal equalization payments to poorer provinces and in funds sent to the provinces to help pay for such services as health, welfare, and higher education, Quebec no longer receives the subsidies it once did from Ottawa. As many Quebecers see it, the federal government will be less and less useful if their province remains in the federation.

A second question raised about the utility of the federal government involves costly duplication of its activities with provincial ones. According to a 1978 study, duplications occur in up to 60 percent of spending programs. Many experts insist that under a sovereign Quebec, significant economies could be made by eliminating these massive duplications.

Quebec nationalists also point out that the numerous overlaps between federal and provincial jurisdictions stir up endless political disputes. They argue that a sovereign Quebec would seem better situated for cooperation between the government, the regions, the unions, and the business class.

Finally, partly as a result of Canada's recent free trade agreement with the United States, many French Quebecers are confident that they can increase trade possibilities with the United States and keep access to the Canadian market even if Quebec becomes an independent country. They no longer believe that the federation offers useful trade advantages.

In sum, Quebec's economic advances, the growth of a francophone business class, the development of all the modern institutions, together with external factors—free trade, the economic and political difficulties of the federal government—have bred a newfound confidence among Quebecers. But that optimism has its limits. In particular, it has been strongly challenged by the deep economic recession that hit the eastern part of North America in 1990–91.

Quebecers saw the rate of unemployment rise above 10 percent. They heard month after month about the successive bankruptcies of enterprises. Many new stars of the Quebec business establishment—Lavalin, Quebecor, Cascades, Malenfant—went through a very tough period and stopped some of their activities. Media coverage became very pessimistic, emphasizing the various difficulties of the province: worries over deteriorating health services and road transport, high dropout rates among students, forest depletion, and problems with Hydro Quebec. In short, a huge contrast arose between the optimistic nationalist language and tough daily reality. It is likely that the contrast contributed significantly to the drop in support for sovereignty registered in the spring of 1991.

Among the elite itself, the new optimism about the economic profitability of sovereignty should not be overestimated. Beginning in February 1991, prominent francophone business leaders in Quebec began to warn that independence would be a "very risky business."

Rejection: the Meech Lake Crisis

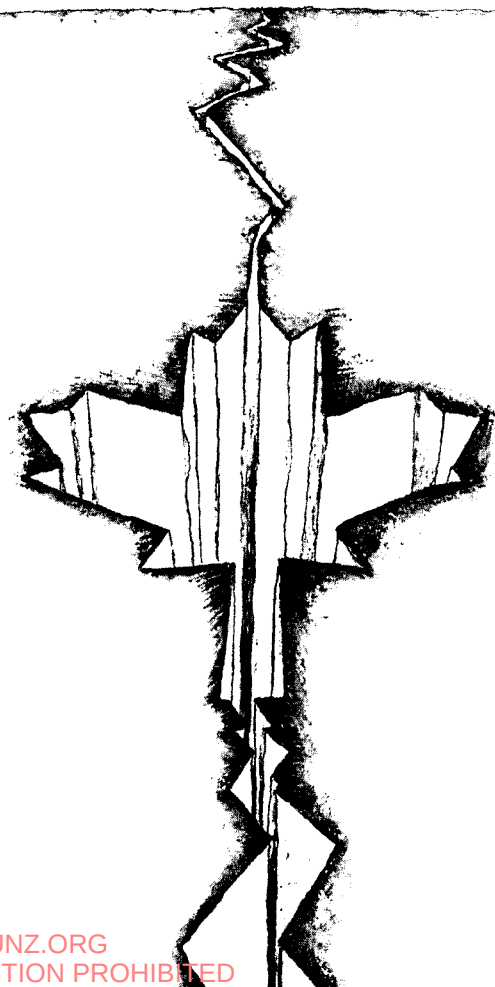
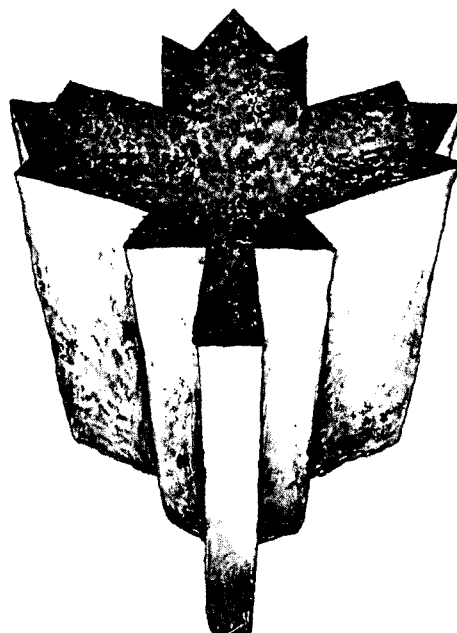
The immediate catalyst in the sudden increase in secessionist support is the rancorous three-year debate over the Meech Lake accord and the ultimate failure of the accord in June 1990. Meech Lake was to have made reparations to Quebec for its virtual exclusion from 1981–82 negotiations over the new constitution, which was endorsed by all the provincial legislatures but that of Quebec. During the negotiations Quebec's premier was René Lévesque, the charismatic *Parti québécois* leader who could hardly have been expected to give his consent to any constitutional agreement, but his isolation—he was not even present during the night of November 4, 1981, when crucial negotiations were held—was, to say the least, inelegant.

In the federal electoral campaign of 1984, Conservative party leader Brian Mulroney, a bilingual Quebecer of Irish descent, committed himself to reintegrate Quebec in the constitution with "honor and enthusiasm." His election as prime minister of Canada legitimized the view that the rest of Canada owed reparations to Quebec.

When the new negotiations began, it was not the separatist Lévesque who sat at the negotiating table, but rather the federalist Robert Bourassa, reelected premier in December 1985. Bourassa brought the shortest list of constitutional demands ever requested by a government of Quebec: recognition of Quebec as a distinct society, a greater role over immigration, a role in appointments to the Supreme Court, limitations on federal spending power, a veto on constitutional amendments. These conditions roughly reflect the terms of the agreement reached at Meech Lake on June 3, 1987, between the prime minister of Canada and the ten provincial premiers. The government of Quebec and Prime Minister Mulroney claimed that they had indeed succeeded in reintegrating Quebec in the constitution.

The federal parliament and ten provincial legislatures had three years to ratify the accord. Signs of trouble began to appear almost immediately. Newly elected premiers in New Brunswick, Manitoba, and Newfoundland declared themselves not committed by the signature of their predecessors. Former Prime Minister Pierre Trudeau, the Liberal Quebecer who had fought ethnic nationalism in favor of his view of a unified multicultural Canada, spoke out forcefully against the Meech Lake accord. According to Trudeau, the accord would debilitate the central government and lead to a gradual secession of Quebec. During the three years of national debate, opposition to the accord never stopped growing outside Quebec, while nationalistic feelings rose in Quebec.

The deadline of June 22, 1990, passed without ratification. Subsequent polls indicated that Canadian opposition to Quebecers' requests was resolute. Close



Just How Strong Is Quebec?

One way to see the strength of the Quebec provincial government is to compare the relative fiscal capacities of different levels of governments in Canada and other countries. Table 1 shows the share of total public revenue going to federal, state, and local government in the four most decentralized OECD countries, Canada, Switzerland, the United States, and West Germany in 1976 and 1988. Canada clearly had the lowest portion of public revenue going to the federal government and the highest portion going to the "states." Moreover, Canada is the only country of the four in which the fiscal weight of the "state" governments gained significantly relative to that of the federal government during the past decade. One must add that the cake is divided among ten provinces in Canada, not among fifty states as in the United States. And because Quebec is Canada's second most populous province, and its government is involved in more fields than that of Ontario, which is the most populous, it is easy to see that Quebec's government is preeminent among subnational governments.



Where Does the Government Revenue Go?

LEVEL OF GOVERNMENT	1976			
	CANADA	SWITZERLAND	UNITED STATES	WEST GERMANY
Federal	49.9	53.2	59.4	62.9
"States"	38.6	25.3	22.9	22.7
Local	11.5	21.5	17.7	14.4

LEVEL OF GOVERNMENT	1988			
	CANADA	SWITZERLAND*	UNITED STATES	WEST GERMANY
Federal	48.1	53.3	59.1	64.0
"States"	41.3	24.6	24.4	22.1
Local	10.6	22.1	16.5	13.8

Source: International Monetary Fund, Government Finance Statistics, 1985, 1990.

* Data from 1984.

to 70 percent of Canadians outside Quebec refused to endorse further concessions to Quebec, even if it meant that the province would separate. For the first time ever, the rest of the country seemed disposed to let Quebec go.

The different reactions of French Quebec and English Canada to the Meech Lake debate can be illustrated quickly. Much of the debate involved setting the rules that judges of the Supreme Court will use to make important collective decisions. It is doubtful that French-speaking and English-speaking Canadians understood—or even cared about—the judicial quibbles. But they understood very simple ideas. As the French speakers saw it, English Canada did not recognize their distinctiveness because it would not agree to enshrine in the constitution the obvious fact that Quebec is a "distinct society." As English speakers saw it, Quebec would get "something" that they would not have, and that "something" would be superior to the human rights inscribed in the Charter of Rights.

During the debate it seemed impossible to accommodate the concept of "strict equality between provinces" with a "distinct society" clause allowed only to the province of Quebec. But the truth is that Quebec in fact has had a special status, partly because, since the beginning of the federation, it has had its own legal system based on the French civil code and also because it has expanded its role in some specific but important fields since the 1960s: a pension plan, immigration policy, and international affairs. Such arrangements were negotiated with the federal government in recent decades in a piecemeal fashion. But in the Meech Lake debate, absolute principles took precedence, and one hardly heard about current realities.

Whether the Quebecers' strong feeling that "*les Anglais* do not want us anymore" will persist is a question. As noted, recent polls show a drop in the support for secession. Ordinarily, relations between English-speaking and French-speaking Canadians are not particularly hostile. Comparative studies show that relationships between linguistic groups in Canada are less conflicting than are those in Belgium and that mutual appreciation of both groups in Canada did not deteriorate between 1968 and 1988. The crucial question is whether the intense resentment that has arisen since 1988 will be short-lived or will endure long enough to convince a majority of Quebecers that they have to leave the federation.

Keep the Focus on Language

The key point is still and will always be the language issue. The government of Quebec will better serve its citizens if it focuses any future negotiations over constitutional issues squarely on language, instead of bringing to the table vague notions such as "distinct society."

That the French language is in such good shape now in Quebec is partly the result of the economic advancement of French-speaking consumers, workers, and investors. But it is also due to the language legislation of the province. There is no doubt that in the absence of Bill 101, immigrants, whose arrival is

particularly important to the province given current demographic trends, would massively have joined the English-speaking community. Bill 101 worked.

It is a great pity that the debate about the commercial signs and all the inside-outside publicity so harmed the image of the Quebec linguistic policy. I feel that a "French necessarily" policy would have been sufficient in this area; but I also think that the "French only" policy was a small discomfort for English speakers and that the widely shared concern of French speakers about the need to send signals to every citizen about the necessity of learning French is understandable. At any rate, the issue is hardly big enough to warrant splitting the country. The key issues are elsewhere, in the two major sections of Bill 101: the language of instruction and the language of the workplace.

With respect to those sections, the Quebec language policy is both necessary for the majority and fair for the minority. Regarding the language of the workplace, the prescriptions of the law set a "predominantly French" policy and not a "French only" one. The target of the language of instruction policy is the new immigrants, who are informed of the law when they come into Quebec. None of those legal requests injured the rights and the institutions of English speakers in the province. French Canadians in the other provinces can only dream about having such conditions.

Quebec's Language Policy Must Be Secured

Quebec policy regarding the language of instruction and the language of the workplace has not been significantly weakened by the various judgments of the Supreme Court. It remains useful and necessary protection for French Quebec. Since the judgments have already been issued, one may think that the survival of those policies is now secured. In fact, nothing may be less certain. American readers are well aware that whatever one group of judges may have decided, their successors may later overturn. It would be conceivable, for instance, that a Supreme Court particularly insensitive to the French Quebec question might decide someday that denying the right of a new immigrant or of a francophone to go to an English school, when English speakers have such a right, is contrary to the Charter of Rights. The Court could invoke to this effect Article 15 prescribing legal equality of all citizens. Such a judgment may seem unlikely today, in the current political context, but who knows what could happen in the next generation? Considering that the French fact will decrease as a demographic reality outside Quebec, and that Quebec's weight will decline in Canada, it is necessary to solidify language protections now.

In a widely discussed paper, Robert Young, of the University of Western Ontario, recommended a unilateral devolution of power over language to the provinces to avoid the risk of destroying the country. Such a reform would fully solve the Quebec problem. But it means also that the French speakers outside Quebec would lose the protection of the federal government. Such a loss would hurt them terribly. It

would be unfair to do it to the Acadian community of New Brunswick, for instance, whose institutions are extensively funded by the federal government and who show a strong resistance to assimilation. Such a reform asks French-speaking Quebecers to press their interest at the expense of other French speakers. It is doubtful that they would accept it. I would not accept it.

To me, the best solution would be a unilateral devolution of power over language only to the government of Quebec, with respect to the Quebec territory. Such a policy would be justified because only the French language is in danger and needs protection and because the rights of the English speakers have historically been well respected by provincial laws and Quebec's Charter of Rights. The English-speaking provinces would not receive the same devolution of powers because the French language needs protection and because nothing in the history of those provinces suggests that they will effectively perform such a duty alone. I would drop the idea that the federal government has "to promote" French-speaking minorities through the country; "to protect" is enough. The French cause is lost in most of the provinces, and it is not worth the trouble to try to revive it.

While such a solution seems reasonable to me, I know enough about English Canada to be aware that it is unlikely to be accepted. It will be stressed that English speakers of Quebec would be alone in receiving no protective status regarding language in the Canadian Charter of Rights and would be left facing a French-speaking majority. With the commercial signs affair still fresh in their minds, I know that the Canadian English speakers would not accept it.

So what can be done? I suggest including in the Canadian constitution a clause assigning to the legislature of Quebec the duty to protect the French-speaking character of the province. Such a clause would secure the interests of the French majority in Quebec without harming the English-speaking Quebecers and the French speakers outside Quebec. With it, I do not see a Canadian court striking down the current policies of the province regarding the language of instruction or the language of the workplace. And since minority linguistic rights are already included in the Charter of Rights, I do not see how it could be perceived as offensive.

In addition, the control of immigration that the province of Quebec already has must be included in the constitution, for obvious reasons. Finally, the province of Quebec must hold a constitutional veto. It is likely that the nine other provinces would ask the same, which would make any ensuing modification of the constitution very difficult. Perhaps that would not be so bad: governments might be dissuaded from losing so much time and energy in never-ending discussions of constitutional reform.

This proposal is a remarkably modest demand coming from a francophone political scientist Quebecer. Still, I think it is not impossible that a majority of Quebecers would buy it. And I cannot imagine that it would be considered excessive by the rest of the country after a reasonable examination. ■

The Enterprise for the Americas Initiative

A Development Strategy for Latin America?

Carol Graham is a guest scholar in the Brookings Foreign Policy Studies program and an adjunct professor in the Department of Government at Georgetown University. Her current research is on poverty alleviation and employment issues in countries undergoing structural reform. This article is adapted from testimony presented to the House Subcommittee on International Development, Finance, Trade, and Monetary Policy in May.

On June 27, 1990, the Bush administration announced the Enterprise for the Americas Initiative, the first comprehensive policy agenda for the entire Latin American region since President Kennedy's ambitious Alliance for Progress. In contrast to the Alliance, which relied primarily on U.S. aid, the Initiative depends on strategies that reflect the budgetary constraints of the 1990s. Its three principal aims are to create a free trade zone in the Americas, to stimulate foreign investment in the region, and to reduce or cancel some \$12 billion in U.S. government loans.

Late in February the president presented legislative proposals that would begin to implement the latter two goals—increasing investment and reducing debt. For some Latin American nations the president's proposals offer real hope for growth and development. Yet for others the conditions necessary to participate in the initiatives the president is proposing are impossible to meet for the foreseeable future.

Although the Initiative has many constructive elements, it is simply too limited in its aims to serve as a comprehensive policy toward the region. As it is now structured, it will leave behind the poorest and most unstable countries of Latin America, with negative economic and political consequences for the region as a whole. If the Initiative is to succeed as a region-wide stimulus to economic progress, it must be made flexible enough to incorporate all the countries of Latin America, and provision must be made for other forms of assistance above and beyond the Initiative.

The February 1991 Proposals

Three proposals are at the heart of the legislation presented by the president in February. First, the president proposes to contribute \$100 million a year for five years to the Initiative's multilateral investment fund to be administered by the Inter-American Development Bank. The money would go for grants to fund specific, market-oriented investment policy initiatives, such as reform of domestic capital markets, undertaken by governments of the region.

The president also plans to establish a special Initiative facility within the Treasury Department to administer the reduction of foreign debt owed to official creditors (as opposed to commercial banks). To be eligible for debt-reduction benefits, a country must have—or, in exceptional circumstances, must have made significant progress toward—a standby arrangement with the International Monetary Fund to enable it to receive temporary emergency credit. A country must also have negotiated a World Bank structural adjustment loan to make specific reforms. It must also have made major investment reforms in conjunction with an Inter-American Development Bank loan or be making progress toward an open investment regime, and, if appropriate, have agreed with its commercial bank lenders on a satisfactory financing program. Eligibility is determined by the president.

For countries eligible for benefits under the Treasury Department facility, the president proposes to reduce debt owed to the United States under the 1961

Foreign Assistance Act, complementing the existing provision for reduction of debts incurred through the Food for Peace program.

In addition, the administration is seeking authority to reduce a portion of assets held by the Commodity Credit Corporation as a result of its credit guarantee facilities and a portion of Eximbank loans to facilitate novel debt-for-equity swaps—in particular, debt for nature and debt for development—in eligible countries. The swaps would entail a foreign creditor forgiving debt in return for “equity” in, say, a newly protected forest or a development project.

The Road to Reform So Far

Latin American nations are in varying stages of the reform process, with their progress often determined by the extent to which they have played by orthodox economic rules in recent years, as well as by the level of development at which they enter the process. Some countries—notably Chile, Mexico, Venezuela, and Costa Rica—have made radical changes in the structure of their economies. They have eliminated subsidies and price controls, repaid and restructured foreign debts, dismantled inefficient state sectors and privatized major industries, and reformed tax, tariff, and labor market structures. The flow of revenues to foreign creditors has been significant, and the social and political costs have often been high. The countries that have paid that price now have relatively stable economies. They are well positioned to participate in the programs of the Initiative, and they are rightly being rewarded for their efforts. They are also ready to compete as equal partners in the free trade framework that the Initiative envisions.

Other countries—Argentina, Brazil, Ecuador, and Peru, for example—are further behind in the reform process and may not be able to qualify for the benefits of the programs the president has proposed. These countries experimented, in varying degrees, with heterodox economic policies in the 1980s. They resorted to price and wage controls, adopted multi-tiered exchange rates, expanded state sectors, and unilaterally reduced or suspended interest payments to foreign creditors. In almost every case the policies eventually resulted in unsustainable hyperinflation, and governments were forced to attempt a return to orthodoxy and a rapprochement with foreign creditors.

Undertaking structural economic reform usually requires challenging entrenched political interests, such as organized labor, state sector workers, and protected industrialists, in addition to undertaking generally unpopular measures such as lifting food subsidies. Yet all the countries in the second category are fragile new democracies, for whom such political obstacles to reform are formidable. The first set of countries, by contrast, underwent the reform process under authoritarian or semi-authoritarian auspices (Chile and Mexico) or already had well-established democratic traditions (Costa Rica and Venezuela). The reform record of the recently constituted democracies has been mixed at best, and the result has often been unstable governing coalitions caught between a state economy and a market economy. These nations must make sub-

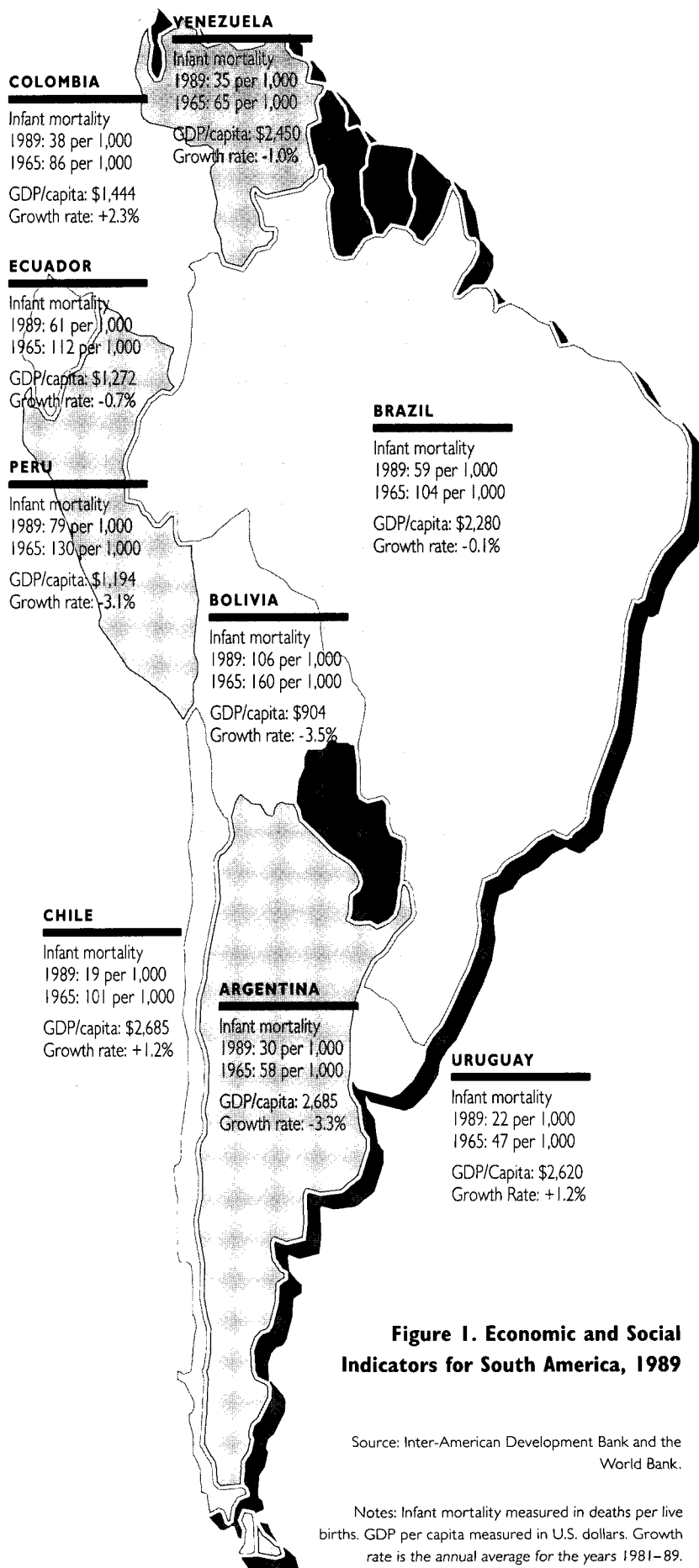


Figure 1. Economic and Social Indicators for South America, 1989

Source: Inter-American Development Bank and the World Bank.

Notes: Infant mortality measured in deaths per live births. GDP per capita measured in U.S. dollars. Growth rate is the annual average for the years 1981-89.

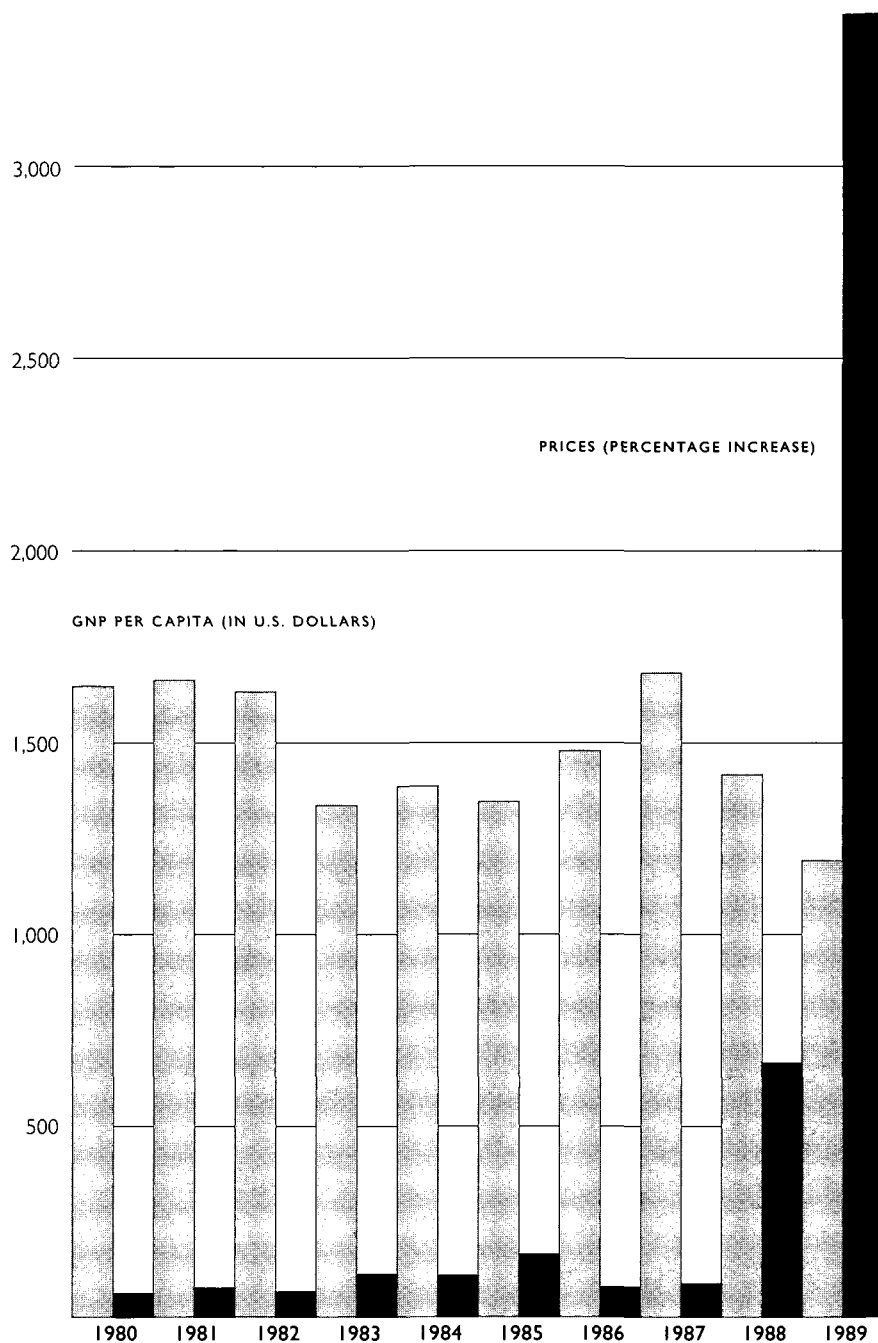


Figure 2. Comparison of GNP per Capita and Prices in Peru, 1980-89

Sources: Inter-American Development Bank and the World Bank.

stantial progress before they are ready to reap the benefits of the Initiative. Some require outside aid to buy time for the internal reforms to produce positive results. Without such aid, for which the Initiative makes no provision, their social and political situations will become unsustainable before the reform process can yield benefits.

A review of the contrasting cases of Chile and Peru illustrates the imperative for flexibility in U.S. policy toward its Latin neighbors.

Chile's Record of Economic Success

Often noted as Latin America's star economic performer, Chile has made the most progress in implementing trade and market-oriented reforms. Its steady growth and low inflation rates in recent years are rare on the Latin continent. Chile is seen as the next candidate after Mexico for a free trade agreement with the United States. It is so far ahead of its neighbors in its structural adjustment that it has little incentive to join the new Southern Cone free market area, Mercosur, or to negotiate free trade with the United States under Mercosur auspices.

Chile has a big stake in success through the Enterprise for the Americas Initiative. The political consensus behind Chile's economic strategy is unusual among Latin American polities. The country has put behind it the discordant years under General Pinochet, who accomplished the nation's far-reaching reform by exacting economic sacrifice through political repression. The transition to democracy with the election of Patricio Aylwin in December of 1989 opened the door to pent-up demand for social welfare spending. Despite relatively good social welfare indicators (Chile's infant mortality rate is the lowest on the continent), income distribution remains highly skewed. In 1989 the wealthiest fifth of the population held 59 percent of total income, while the poorest fifth had 3.5 percent. Yet fiscal balance remains the pillar of Chile's economic stability. In 1990 the new government slightly increased the tax on business profits to create a resource base for increased social spending. Continued growth will thus be essential to fund that base.

Chile relies increasingly on foreign trade for economic growth. Exports accounted for 30 percent of gross domestic product in 1990 and are projected to grow to 34 percent by 1994. The nation's vulnerability to protectionism became particularly clear during the U.S. boycott of Chilean fruit in March 1989 after the discovery of two poisoned grapes. The boycott cost Chile some \$300 million in lost revenues, about 5 percent of total annual export revenues. Understandably, U.S. and European Economic Community tendencies toward protectionism worry Chile, and a free trade agreement with the United States is a top priority. A failure in free trade negotiations with the United States could endanger Chile's new democracy, eroding the existing consensus and playing into the hands of extremists on both sides of the political spectrum. Chile does not need—nor is it asking for—aid. It requires only equal treatment as a trading partner.

Within the Initiative, Chile stands to benefit the

most from the proposed free trade framework. The Initiative's debt reduction provisions have limited relevance, for Chile has serviced its debt without interruption and without special treatment or reduction for years. Chile has only \$60 million in debts in the Foreign Assistance Act category that President Bush wants to make eligible for reduction, a very small amount relative to Chile's total debt of more than \$18 billion. In the investment arena, the new Treasury facility may serve Chile well, as Chile's relatively strong economic position limits its access to concessional multilateral credit (credit on favorable, below-market-rate terms). Although Chile attracts substantial foreign investment, the government needs additional funds—which it presumably could get through the Treasury facility—to improve the country's underdeveloped domestic capital markets.

The United States also has a big stake in Chile's successful participation in the Initiative. If Chile, the model performer in Latin America, cannot benefit from the Initiative, poor performers will have no incentive to reform. The Bush administration demonstrated its recognition of this fact by signing, on the first anniversary of the Initiative, an agreement to reduce Chile's \$39 million Food for Peace debt by \$16 million. While the move had symbolic importance, it is of little significance in light of Chile's total debt.

The key issue for Chile within the Initiative remains free trade with the United States. Yet a free trade agreement could be more than two years in coming, as the administration is currently preoccupied with negotiating with Mexico. Many Latin nations attribute the possibility of a U.S.-Mexican free trade agreement to Mexico's proximity to the United States. An agreement between the United States and Chile would do much to convince them that free trade agreements with the United States are possible for all Latin countries who make the necessary reforms. The failure of such an agreement could lead to support for extremist politicians in nations such as Brazil and Argentina, where the reform process is in its most difficult stages. The successful negotiation of Initiative provisions with Chile is an important first step toward realizing the overall objectives of the Initiative and is critical to its region-wide implementation, as well as to U.S. economic and political interests in the region.

Can Peru Make It Back?

Peru is the most extreme case of an economy that did not play by the rules in the 1980s. Alan Garcia's populist economic strategies ultimately led to economic chaos and collapse: a 20 percent drop in gross domestic product in 1988–89, the second longest hyperinflation in world history, a 50 percent drop in real wages, and an underemployment rate of 75 percent. By 1990 the state had virtually ceased to function. Public sector workers were not even paid for the last two months of the Garcia government. Peru's tax base for state expenditure was 7 percent of GDP in 1990, equivalent to that of the poorest of developing countries, Uganda and Bangladesh (France's tax base, by contrast, is 41 percent of GDP, and the United Kingdom's is 36 percent). Garcia's hostility to the International Monetary

Fund and his strategy of unilaterally limiting Peru's debt payments gave his country the dubious distinction of being Latin America's worst debtor. Peru is also the world's largest producer of coca leaf, an occupation to which its citizens have turned increasingly in the absence of other opportunities. Despite the fall in the price of cocaine on world markets, the number of peasants involved in coca-growing activities has increased to hundreds of thousands.

Economic deterioration, social upheaval, and criminal and political violence threaten the country's democratic system and even its civil society. The insurgent activities of the Maoist, Khmer Rouge-like Shining Path guerrilla movement in the context of fragile democratic institutions have led to spiraling violence and unrestrained human rights abuses. More than twenty thousand people have died since Shining Path launched its activities in 1980, and Peru ranks number one in the world in the number of disappearances. Lack of resources, an underdeveloped judicial system, and the overwhelming challenge from guerrilla movements, paramilitary groups, and criminal violence have led to the military's having de facto control over the large portions of the country under emergency rule. In the drug-producing regions of the country, meanwhile, the Shining Path has a strong following because it serves as a protector of sorts for the local coca-growing population, guaranteeing that they are paid a fair price by the drug traffickers.

Peru's crisis has economic and strategic implications for the entire region, as well as for the success of the Initiative. The costs of the nation's economic deterioration have risen beyond the inconvenience of illegal immigration and contraband trade at neighboring borders. The cholera epidemic that broke out in Peru in February has spread to Colombia, Ecuador, Chile, and Brazil. The disease is likely to become endemic in poor areas in many of these countries. Members of Peru's various insurrectionary movements, meanwhile, have committed violent acts or been captured in Bolivia, Ecuador, and Colombia.

Initiating Reform

Soon after taking power in July of last year, the government of Alberto Fujimori made a commitment to reverse Peru's economic deterioration and repair its relations with the international financial community. It launched a draconian austerity plan to stabilize hyperinflation and build up sufficient revenues for the government to operate. Monthly inflation fell from 400 percent to about 10 percent. Subsequently the Fujimori government has embarked on an impressive series of structural reforms. It has lowered and reduced the number of tariffs, eliminated most subsidies and nontariff trade barriers, and is attempting to implement tax reform. It has also reformed a restrictive labor code that had made it virtually impossible to fire workers and thus discouraged hiring. Finally, it has provided incentives for early retirement for public sector workers. It also plans to privatize several state industries and has begun by putting the nationally owned airline up for sale. Indeed, almost overnight, Peru has become a perfect example of orthodox economic policy reform

and is implementing changes at a pace that is unprecedented on the continent.

Yet the reforms are costly. Eliminating subsidies and price controls raised the price of food an average of 500 percent and increased the price of gasoline 3,000 percent. These price changes were calamitous for most Peruvians, particularly the poor. Overnight the number of people living in extreme poverty—that is, without enough income to meet basic food needs—rose from 7 million to 12 million, slightly over half of Peru's population. Per capita GDP now stands at 1960 levels. Stories of babies dying of malnutrition at home because their mothers cannot afford the bus fare to the clinic are common in Lima's slums. The infant mortality rate in Peru is 79 deaths per thousand live births and is on the rise. In neighboring Chile it is 19 per thousand; in Colombia it is 38. Unemployment, meanwhile, is growing as small businesses face extreme recession on the one hand and the removal of subsidies and the introduction of unrestricted foreign competition on the other. The most recent statistics for Lima found that only 9 percent of its economically active population was adequately employed. Although the government has promised to implement a social emergency program to provide food and temporary work, it has yet to do so, largely because of a lack of resources.

Rejoining the international financial community also has its costs. Peru is seeking a \$1.3 billion loan from a support group of friendly countries in order to keep current on its payments to external creditors and gradually to clear its arrears with the IMF and the World Bank. Even if it is able to obtain the full loan, it will still have to pay out an additional \$600 million in domestically generated resources. Its current *monthly* payments of \$60 million to the IMF and World Bank are more than the government has spent in its whole tenure in office on the desperately needed emergency social program. The payment of arrears is the necessary bitter medicine for reestablishing financial credibility. Yet with economic conditions as they are, the government cannot raise the revenues it needs at home, much less those to send abroad.

Cholera's Heavy Toll

The cholera epidemic has added a formidable and unexpected obstacle to the prospects of economic recovery through free trade. The epidemic has had disastrous effects on Peru's two key foreign exchange earners, tourism and fisheries. The major tourist agencies reported a 50 percent drop in sales two months after the epidemic broke out. Estimates of lost tourist revenue for 1991 are \$8 million. Peru earns an average monthly income of \$38 million from fisheries exports. In February alone, losses were estimated at \$13 million. Sales of restaurants and street vendors have also dropped dramatically, in the process weakening an important part of the informal economy that acts as a social security of sorts for those unable to find steady jobs.

Human costs of the epidemic are also enormous. To date almost 200,000 cases of cholera have been reported in Peru. More than 1,500 people have died.

Cholera, which is spread by contaminated water and seafood, is essentially a poor man's disease. Although it is easily treatable with antibiotics and oral rehydration, it can be fatal in as little as four hours without medical attention. For most of Peru's poor, adequate medical care is hard to come by. It is virtually nonexistent in some of the more remote shantytowns or rural regions. Peru's water treatment and sewage infrastructure is so bad that even if medical care were available, it would take several years to extend services to most poor areas. With a population of 7 million, Lima has infrastructure for fewer than 3 million people.

Roadblocks to Success

Even if Peru continues its valiant efforts to restore economic order and implement an orthodox economic strategy, the obstacles are enormous. For any economic strategy to succeed, some semblance of social order and political stability is necessary. Neither exists today. Attaining them requires immediate attention to sorely neglected basic social welfare issues and to reform of severely underdeveloped and overburdened judicial institutions. The efforts will require financial resources that are clearly not available in Peru. Foreign aid must provide both the resources and the technical support to fight the cholera epidemic and to begin to restore and develop the nation's social welfare infrastructure. Foreign aid is also necessary to provide food and temporary employment until the economy has time to recover. A particular focus of such a program should be unemployed youth, who are the principal targets of insurgent groups such as Shining Path.

Foreign aid is obviously not the sole answer. Peru's problems, first and foremost, must be solved at home. Yet resources from abroad are critical. Peru's turn to a free market strategy could make it a participant in the Initiative in the long run, but for now the obstacles are too great. Support for Peru, at least for the near future, must come from outside the Initiative, as well as within it if and when possible.

Peru, however, cannot now meet the conditions demanded by the Initiative. It has neither a standby agreement with the IMF nor structural adjustment loans from the World Bank. It has not rescheduled its private bank debts. After almost 12 months of negotiations, the proposed bridge loan to cover its arrears to the IMF has yet to materialize fully. The process of clearing arrears with the World Bank is also yet to be resolved. At the very earliest, new lending could begin at some point in 1992. An agreement with private creditors will be much longer in coming. In addition, any kind of debt-for-equity swap such as proposed by the Initiative has limited relevance for Peru, whose debt has a market value of as little as 4 cents to the dollar. Where Peru stands to gain the most from the Initiative is from forgiveness or reduction of Foreign Assistance Act and Food for Peace debts, as arrears alone on these two forms of debt are \$54 million and \$30.8 million, respectively. Yet progress on this front is hindered by Peru's failure to meet the other requirements, and, unless they are waived, Peru will have little to gain from the Initiative.

Complicating all proposed aid to Peru is the issue

of drugs. No financial aid from the United States or any multilateral institution in which the United States has a veto vote can go to Peru until the United States and Peru sign an agreement to cooperate on drugs. While an agreement in principle was signed on May 15, annexes are still being negotiated on several sticking points. One is coca eradication. For the Peruvians, providing alternative employment to growers comes first. For the United States, eradication and interdiction come first. Peru also puts a higher priority on curbing the growth of Shining Path than on fighting the drug trade. Peru fears that using its military, and possibly U.S. personnel, to eradicate coca runs the risk of turning hundreds of thousands of displaced farmers into supporters of Shining Path. Quite justifiably, the resource-strapped Peruvians see the cocaine problem as generated by U.S. demand for drugs. Although the drug cooperation agreement will probably be signed some time in the near future, the negotiations have dragged on almost six months, stalling valuable aid efforts. Other potential donors, such as the Japanese, are waiting for the U.S. "go ahead." Although the U.S. Agency for International Development has approved some \$100 million in food aid to Peru for 1991, it is unable to initiate any new projects or disburse money until the agreement is completed.

The extremity and severity of the Peruvian case dictates commitment from the highest levels of the U.S. government that goes well beyond our current approach. Peru can and will make progress on the cocaine production front—just as it is doing on the economic reform front—only when it can meet the most basic needs of its people. It can do so only with substantial aid from abroad. If the situation continues to deteriorate, it will affect the entire region's economic and strategic interests and the Initiative as a whole. As the cholera epidemic shows all too well, Peru's troubles cannot be confined within its borders.

The Initiative and Beyond

The Enterprise for the Americas Initiative is clearly correct in its strategy of rewarding good performers such as Chile, and it should follow through on its promises to do so. Yet the Initiative cannot be a comprehensive development policy for the region. Although Peru's case is extreme, other countries, such as Bolivia, Ecuador, and Brazil, are also attempting to make structural economic reforms in the face of severe poverty and political instability. They must be encouraged to develop not only the trade and investment reforms proposed by the Initiative, but also sorely needed reforms in health, education, and basic service infrastructure. The poorest countries, Peru, Ecuador, and Bolivia, will need foreign aid above and beyond debt reduction to do so. Progress on both fronts will go a long way toward building a stronger base, both economic and political, for structural economic reform. Without such progress, these countries will not be able, for the foreseeable future, to compete as equal trading partners and will be relegated to a marginal status. If that happens, and if their economic and political health continues to fail, the entire region could pay a heavy price. ■

The Enterprise for the Americas Initiative is clearly correct in its strategy of rewarding good performers, and it should follow through on its promises to do so. Yet the Initiative cannot be a comprehensive development policy for the region.

DOES PRISON PAY?

THE STORMY NATIONAL DEBATE OVER THE COST-EFFECTIVENESS OF IMPRISONMENT

John J. DiIulio, Jr., and Anne Morrison Piehl

Today the U.S. prison population is hovering around the 800,000 mark. Before the end of the decade, it will easily surpass one million. Most analysts place the average annual cost per prisoner at \$25,000, and the labor-intensive business of penal administration would appear to offer no appreciable economies of scale. Building, staffing, and paying for prisons is the fastest-growing item in most state budgets. Not surprisingly, a debate is raging over the cost-effectiveness of imprisonment. The debate is being waged as a numbers game, with conservatives citing figures to show that "prison pays," and liberals citing figures to insist that it doesn't. So far, partisans appear not to have noticed that the kind of empirical analysis that would justify strong generalizations on either side of the argument has yet to be done.

Given the fledgling state of empirical work, we question the wisdom of the rush to judgment. Our argument, which is based on our analysis of prisoner self-report survey data gathered from the largest scientifically selected sample of prisoners in a single system ever undertaken, moves from a simple benefit-cost analysis of imprisonment. Needless to say, such an analysis addresses many empirical and normative issues weakly or not at all. But benefit-cost analyses of imprisonment have figured prominently of late in national debates about corrections policy, and many judgments about the efficacy of imprisonment policies rest on implicit estimates of the costs and benefits of imprisonment.

The Zedlewski Controversy

In July of 1987 the National Institute of Justice published a report entitled "Making Confinement Decisions," by NIJ economist Edwin Zedlewski. Essentially, Zedlewski's study was a benefit-cost analysis of imprisonment. He surveyed cost data from several

prison systems and estimated that the annual per prisoner cost of confinement was \$25,000. Using national crime data and the findings of criminal victimization surveys, he estimated that the typical offender commits 187 crimes a year and that the typical crime exacts \$2,300 in property losses or in physical injuries and human suffering. Multiplying these two figures, he calculated that, when on the streets, the typical imprisoned felon was responsible for \$430,000 in "social costs" each year. Dividing that figure by \$25,000 (his estimate of the annual per prisoner cost of confinement), he concluded that incarceration has a benefit-cost ratio of just over 17. The implications were unequivocal. According to Zedlewski's analysis, putting 1,000 felons behind prison bars costs society \$25 million a year. But not putting these same felons behind prison bars costs society about \$430 million a year (187,000 crimes times \$2,300 per crime).

At least within criminal justice circles, NIJ's reports tend to get noticed, and like any study that bucks the conventional wisdom in a credible (or credible-looking) way, Zedlewski's analysis attracted its share of critical attention. In a 1988 article, "The New Mathematics of Imprisonment," published in the journal of the National Council of Crime and Delinquency, noted penologists Franklin E. Zimring and Gordon Hawkins charged that Zedlewski's analysis was fatally flawed. Zimring and Hawkins argued that Zedlewski had overstated the net benefit of incarceration by inflating the numerator (crimes per offender and social costs per crime) and deflating the denominator (annual per prisoner costs of confinement). They cited several good studies to bolster their charge, including one indicating that the typical offender commits fewer than 20 (as opposed to 187) crimes in a year.

But Zimring and Hawkins did not use their insights into Zedlewski's methodological errors to recalculate

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the benefit-cost ratio of imprisonment. Instead, they asserted that such measures were inherently unreliable, dismissed Zedlewski's study as "the wrong dog barking up the wrong tree," and concluded by lamenting that, despite sharp escalations in the nation's prison population, many people continue to demand more prisons. They were joined by other critics who, in effect, wanted to have their corrections cake and eat it too. The logic of Zedlewski's fiercest critics was like the logic of nihilists who insist not only that people believe in nothing but in their particular brand of nothing. Metaphorically speaking, one is free to believe that the benefit-cost ballpark doesn't exist, but having taken that position, one cannot logically proclaim anyone to be out in left field (or, in this case, right).

There was, indeed, no shortage of serious methodological and related problems with Zedlewski's analysis. Zedlewski, for example, quoted the results of a survey by the RAND Corporation that "inmates averaged between 187 and 287 crimes per year, exclusive of drug deals." Although he noted that half the inmate population committed fewer than 15 crimes a year, so that the median number of crimes committed was 15, he used the mean (or average) in his analysis. Making this one adjustment (using 15 rather than 187 for the number of crimes averted through incapacitation of a criminal) reduces the benefit-cost ratio to 1.38.

Zedlewski's research also brings up several aggregation issues, both across crimes and across jurisdictions. The RAND survey, of offenders in prisons and jails in California, Michigan, and Texas, contained self-report data on criminal activity, demographics, and criminal records. The survey reported that inmates who committed burglaries averaged between 76 and 118 annually, while lesser thieves reported they averaged be-

tween 135 and 202 thefts a year. Although there is substantial variation in offense rates, the general pattern is that the pettier the crime, the more frequent the offense. Zedlewski's use of averages obscured these distinctions and inflated savings estimates.

Also obscured in the big picture drawn by Zedlewski are the differences among jurisdictions. States vary in many ways, including laws and the austerity with which they are enforced, the structure of the prison and jail systems, the generosity of the welfare system, and economic vitality. These differences influence the benefit-cost calculation by affecting the costs of incarcerating individuals and the characteristics of the arrested offenders. States that imprison a high proportion of offenders are likely to gain less at the margin than states known for their liberal attitudes toward imprisonment. Whereas the Zedlewski approach in a sense gives a benefit-cost estimate for the nation, a measure at the state level, which is the decisionmaking unit, is of more policy relevance.

Beyond Willie Horton

The controversy surrounding Zedlewski's analysis widened with Richard B. Abell's 1989 essay "Beyond Willie Horton: The Battle of the Prison Bulge," published in *Policy Review*, a journal of the Heritage Foundation. In this article, Abell, an Assistant Attorney General of the United States, repeated Zedlewski's findings. He used anecdotes to put flesh on the reality behind the numbers and to illustrate the potential costs of not imprisoning criminals. For example, Abell recounted the tale of a Michigan prisoner who in 1975 brutally shot and killed two people in a Detroit bar. A plea bargain reduced the killer's two first-degree murder charges to second degree, and he received a 20- to 40-year prison term. But on the day he entered prison

A DEBATE IS RAGING OVER THE COST-EFFECTIVENESS OF IMPRISONMENT, WITH CONSERVATIVES CITING FIGURES TO SHOW THAT "PRISON PAYS," AND LIBERALS CITING FIGURES TO INSIST THAT IT DOESN'T.

he was automatically granted nearly 10 years of “good-time” credits. He kept those credits even though, after dozens of serious disciplinary infractions, his behind-bars behavior was anything but good. His confinement time was further reduced under the terms of state laws designed to relieve prison overcrowding. In 1984, after serving only eight and a half years of his minimum sentence, the killer returned to the streets. Within three months of his early parole, he and a female accomplice—a fugitive who had been serving time in a halfway house—killed again. This time the victims were a young woman, who was shot as she opened her front door, and a local policeman, the father of six children.

Abell’s article generated a storm of commentary, especially after an excerpt from it appeared as a featured op-ed essay in the *Wall Street Journal*. In addition to railing against Abell’s use of a graph that showed crime rates falling when imprisonment rates go up, many experts challenged his uncritical reliance on Zedlewski’s findings and ridiculed his use of “sensationalistic” anecdotes such as the one summarized in the preceding paragraph.

Abell’s crime-imprisonment graph was misleading, but not half as much as the critics’ assertion that no relationship exists between the probability of being imprisoned and the propensity to commit crime. Based on existing statistical evidence, the relationship between crime rates and imprisonment rates is ambiguous. By the same token, Abell’s embrace of Zedlewski’s analysis was uncritical, but no more so than the facile rejection of the same by his (and Zedlewski’s) critics.

Finally, there was nothing sensationalistic about Abell’s account. Policies that effect the release of convicted criminals have consequences, some of them ugly. It is not sensationalism to recount true stories of innocent people whose lives were ruined as a result of these policies. And it is not responsible to bury detailed evidence of the harms caused by these policies alongside their victims. Indeed, the Michigan killer discussed by Abell was atypical in that he had served *more* time in prison than most murderers now do. After lavishing good-time credits on its prisoners and reducing their sentences to relieve overcrowding, Michigan released thousands of violent criminals who had served less than half of their sentences in confinement, with tragic results for many of the state’s citizens. Similar policies and programs have operated with similar results in many jurisdictions.

Still, the public debate over imprisonment policy is not enriched by analyses, systematic or anecdotal, that overdramatize the benefits of keeping criminals behind bars. Weighing in on the other side, in a September 1989 report, the RAND Corporation summarized and endorsed the academic and popular literature critical of Zedlewski’s analysis. In a footnote, RAND stressed that Zedlewski had erred in using the mean figure of 187 crimes a year, when the median figure was 15 crimes a year. The report as a whole stressed the need to compare the costs and benefits of imprisonment to the costs and benefits of other correctional sanctions, especially intensively supervised probation programs.

The debate, however, has continued. Zedlewski has defended his research against its critics, and the chief finding of “Making Confinement Decisions” continues to be cited as settled fact in the popular media. In the November 1990 issue of *Reader’s Digest*, for example, Zedlewski’s 1987 study was cited to support the argument that “to pen every serious offender will cost billions, but it’s money well spent.” The entire text of the article was reprinted as a full-page ad in the *New York Times* on October 17, 1990.

Last December one of us published a report on corrections in Wisconsin that featured an analysis of the benefits and costs of imprisonment in that state. The report, published by the Wisconsin Policy Research Institute, accounted for many of the methodological problems in Zedlewski’s analysis, and estimated the benefit-cost ratio to be a little less than 2. Nevertheless, fierce critics of the Zedlewski study, such as the National Council on Crime and Delinquency, charged that the Wisconsin report was meaningless, ignored its qualifications, and caricatured its contents. Meanwhile, individual champions of the Zedlewski study charged that the Wisconsin report understated the net benefits of imprisonment.

Estimating Crime Commission Rates

Hope for rational, nonideological discourse on this important public policy issue nevertheless springs eternal. Reasonable minds can and do differ over how best to conduct cost-benefit analyses of imprisonment policies, how best to interpret the results of such analyses, and how, if at all, to fashion or reorient public policies accordingly. Based on our reanalysis of relevant 1990 survey data from a scientifically selected sample of more than 7 percent of the Wisconsin male prison population, however, extremists on either side of the Zedlewski debate are bound to be disappointed. In Wisconsin, the net benefits of imprisonment are neither as large as Zedlewski’s analysis would predict nor as minuscule as Zedlewski’s strongest critics would assert.

We follow other analysts, including Zedlewski, in excluding the effects of incarceration on future crime rates through general deterrence, rehabilitation, or further criminalization of the offender. Because the applied research in this field gives us no firm basis for concluding that the net effects of prison time on future criminality are significantly positive or significantly negative, we focus on incapacitation (based on prisoners’ self-reported past history)—that is, the number of crimes averted because the offender was kept off the street.

As other researchers have noted, a few offenders seem to be responsible for the majority of crimes committed, while the bulk of offenders commit a few crimes each. To illustrate this, table 1 shows four different ways to measure the number of crimes committed per prisoner per year in Wisconsin. The average (mean) number of crimes per prisoner per year including drug sales is estimated to be 1,834. The mean number of crimes excluding drug sales is 141. The median number of crimes including drug sales is 26. The median number excluding drug sales is 12.

Table 1. Wisconsin Prisoners' Yearly Crime Rate

	INCLUDING DRUG SALES	EXCLUDING DRUG SALES
Average	1,834	141
Median	26	12

Source: Calculations from the 1990 Wisconsin Prisoner Survey.

It is worth noting here that most analysts have omitted drug sales from their calculations of the net benefit of imprisonment. There is no pure methodological reason why drug sales should not be included in such calculations. Drug sales are crimes, and they involve both direct and indirect social costs. Systematic empirical knowledge about the economic and other consequences of drug sales is scarce. Such data as exist—for example, the June 1990 RAND report on drug dealing in Washington, D.C.—do not point clearly in the direction of leaving drug sales out of such calculations. The issue is complicated by individual moral attitudes toward the distribution of illegal drugs. Some people view drug sales as “victimless crimes” and favor drug legalization, while others view drug sales as serious crimes at the root of many other criminal activities and social ills. Either view may affect one’s inclination to include drug sales in calculations of the net benefit of imprisonment.

This is not the place to referee the drug debate. We note, however, that a main reason why drug sales are widely viewed as socially harmful is that they are believed to be strongly correlated with other criminal activities. In the analysis that follows, although we will follow previous studies in excluding drug sales, we will focus on several types of criminal activity that have been associated with drug involvement.

Estimating Social Costs of Crime

Estimating prisoners’ yearly rates of committing crimes is only the first step in our analysis. The next step is to estimate how much these crimes would cost society were the prisoners free to commit them. Or, to put it another way, our next step is to estimate how much society benefits from protecting itself from these crimes through imprisonment. Analytically, it is a complicated step, but not an impossible one.

The reason for the complexity should be rather obvious: different crimes impose different social costs. Other things being equal, a bank robbery in which someone is killed or seriously injured is more costly to society than a bank robbery in which no one is harmed. But does every burglary impose the same social costs as every other burglary? Is a petty burglary more or less costly to society than an attempted car theft that ends in vandalism? Are either or both of these crimes more or less injurious to society than a routine drug sale? Generally speaking, without being arbitrary it is difficult to rank categories of crimes in terms of their social costs, and

difficult to translate these costs into dollar values.

Indeed, it is often difficult even to classify a convicted offender as a “robber,” “burglar,” or “drug dealer.” About one-third of the property offenders we surveyed, for example, acknowledged involvement in more than one category of crime in the four months before their most recent arrest. Among other problems, official information on a prisoner’s conviction charge and past criminal record is often contaminated by plea bargaining and the exercise of judicial discretion.

In the face of these difficulties, the analyst has at least two options (apart from throwing in the towel). One option is to come up with a single estimate of the social cost per crime. In previous studies, many analysts (ourselves included) have done just that. As noted above, Zedlewski used an estimate of social costs per crime of \$2,300. Others have argued for and used both higher and lower estimates. While not totally without merit, the single estimate approach results in grossly oversimplified calculations and does not enable one to specify the net benefit of imprisonment for any given category of offenders. In addition, that approach does not capture the differences in the “crime mix”—that is, the types of crimes most frequently committed—from one jurisdiction to the next.

A second option, and the one we will exercise here, is to restrict the analysis to given types of crimes. The two basic categories of crime are violent crime and property crime. We know enough to make social cost estimates for certain types of property crime (robbery, burglary, auto theft, and fraud, forgery, and petty theft) and for at least one type of violent crime (assault). So we will restrict ourselves to an analysis of the net benefit of imprisonment for these crimes.

Using data drawn from the National Crime Survey and from a study of jury awards in cases involving pain and suffering and time lost from work, Mark A. Cohen has estimated the dollar values of these crimes (table 2). The estimates account for pain and suffering, risk of death, lost wages, and medical costs for psychological injury resulting from the crimes. Still, we acknowledge that further research is needed to refine these measures.

Table 2. Estimates of Social Costs of Selected Crimes

CRIME	SOCIAL COST
Robbery	\$ 12,060
Assault	11,518
Burglary	1,314
Auto theft	2,995
Fraud, forgery, petty theft	110

Source: Mark A. Cohen, “Pain, Suffering, and Jury Awards: A Study of the Cost of Crime to Victims,” *Law and Society Review*, vol. 22, no. 3 (1988). We have revised Cohen’s estimates to account for inflation and transfer of wealth.

PARTISANS APPEAR NOT TO HAVE NOTICED THAT THE KIND OF EMPIRICAL ANALYSIS THAT WOULD JUSTIFY STRONG GENERALIZATIONS ON EITHER SIDE OF THE ARGUMENT HAS YET TO BE DONE.

The Net Benefit of Imprisonment

To assess the net benefit of incapacitation we must make some assumptions regarding who would be incarcerated if prison capacity were expanded at the margin, say by 100 cells. Some researchers have considered lengthening sentences of those currently convicted, for example, by 10 percent, assuming they would remain as criminally active as they reported having been before their arrest. On the basis of evidence that the *probability* of being punished has more deterrent effect than the *degree of the sanction*, we believe a more practical alternative is to consider sending more offenders to prison. Zedlewski followed the same approach.

We have ranked the respondents to the Wisconsin survey according to their "social costliness" in the months just before arrest (see table 3). For each offender we calculated the total cost of having him on the street for a year, committing crimes at the rate he reported on the survey. For example, we simply multiplied an estimate of the number of robberies he would commit times \$12,060, giving us a measure of the cost of robberies he would do. Then we added a similar measure for the impact of his assaults (the number of assaults times \$11,518 each), continuing the process for each crime listed in the table. For technical reasons in the way the estimates were constructed, the resulting measure of "social costliness" is probably biased upward somewhat.

Table 3 summarizes the statistics for the whole sample. It may be more illustrative, however, to consider the criminal activities of a few actual offenders, shown in table 4. As expected from our earlier observation that a few individuals are responsible for most crimes, the distribution of social costs is seriously skewed—an important fact in interpreting the analysis. Offender A committed robberies at a rate of 151 a year and assaults at the rate of 12 a year, at a social cost of almost \$2 million dollars. Offender B committed 3 robberies and 3 assaults a year, at a social cost of \$70,734. Offender D is considered the "median" offender; half of those surveyed were more costly than he, half less costly. Actu-

ally there are several inmates who fit this profile, having committed 4 assaults a year. The offender at the 25th percentile cutoff, offender E, committed 12 burglaries with an estimated \$15,768 in social costs. Taking a simple average of social costs of all of the property or assault offenders gives a mean value of \$369,131.

Table 3. The Social Cost of Property and Assault Crimes per Offender

OFFENDER	COST
Average (mean)	\$ 369,131
Median	46,072
25th percentile	15,768
10th percentile	1,980

Source: Calculations from the 1990 Wisconsin Prisoner Survey.

Because attaching dollar values to criminal acts is much more contentious for such crimes as murder and rape, we do not consider those crimes here. In fact, we would venture that it is impossible to make an argument for incarcerating murderers based on projected social savings. Most murderers are not expected to kill again because their crime was one of passion or the result of drinking or drug use. Arguments for their imprisonment must be based on retribution and deterrence, which are quite valid, though not part of the current discussion.

Table 5 transforms the social costs associated with different prisoners in the Wisconsin study into benefit-cost ratios by dividing the numbers in table 3 by the cost of incarcerating an offender. We use an estimate of \$25,000 per prisoner per year, which accounts for cell construction costs and operating expenditures.

It clearly does not "pay" from an economic standpoint to keep the least criminal offenders behind bars. But how do we know which estimate is appropriate to

Table 4. Sample Criminal Profiles for Wisconsin Prisoners

	ROBBERIES	ASSAULTS	BURGLARIES	AUTO THEFT	OTHER THEFT	SOCIAL COST
A	151	12				\$ 1,959,276
B	3	3				70,734
C	3		12			51,948
D		4				46,072
E			12			15,768
F					18	1,980

assess current imprisonment policy? First, we need to define which of the current inmates the hypothetical additional 100 prisoners would be most like. To answer this question we need some evidence of how well the criminal justice system sorts out the high-rate, high-cost offenders. This depends on the degree to which police officers make accurate judgments about whom to arrest, how the ardor with which public defenders argue their clients' cases is related to criminality, and judicial decisions regarding the type and severity of sanction imposed. One technique for approaching this issue would be to compare self-reports of those sentenced to probation to those sent to prison to see how well judges and the participating attorneys do.

Table 5. Benefit-Cost Ratios of Incarceration for Selected Types of Offenders

OFFENDER	RATIO
Average (mean)	14.77
Median	1.84
25th percentile	0.63
10th percentile	0.08

But even without such information, we can still learn something from the benefit-cost ratios of table 5. Using the mean of the incarcerated population as a proxy for the costliness of the next person imprisoned for a property crime implies that you think the system is unable to do any sorting. If this assumption is true, increasing the number of prison beds is desirable public policy, as nearly \$15 in social costs is saved for every \$1 added to the imprisonment budget. Alternatively, the choice of the median as an admittedly blunt instrument implicitly assumes that the corrections community can ascertain whether an offender is likely to be in the most active half of the detained population, but cannot make a more specific determination based on the type of information to which they generally have access. This measure implies that the scope of corrections is just about right. On the other hand, if the system can precisely sift out the more active and more costly criminals, we are overinvesting in prisons.

In a 1982 RAND Corporation report, Peter

Greenwood, with Allan Abrahamse, helped kick off a "selective incapacitation" debate by proposing that it is possible to identify and incarcerate only the very active criminals, thus achieving the same crime rate with a much lower prison population and saving a great deal of taxpayers' money. The upshot of the debate, however, is that it is difficult to precisely identify those offenders with information generally available to the criminal justice system. A believer in the efficacy of selective incapacitation would maintain that we could concentrate on the most hard-core criminals, freeing the lowest quartile of inmates. In future work we will focus on more precise definitions of who the "marginal offender" is and how to assess his likely level of criminal behavior under such sanctions as parole or early release.

Policy Implications

Though one cannot conclude whether or not prison pays at the margin without further evidence on where that margin lies, we venture that the criminal justice system is able to do enough sorting that the margin will fall below the mean but above the 10th percentile. Consider, for example, using the median cost of a property offender as the estimate of the social cost of the crime committed by the marginal offender. The net benefits of imprisonment can then be expressed as follows. Imprisoning an additional felon costs the state \$25,000 a year, but letting him freely roam the streets in search of victims costs society \$46,072 a year; imprisoning 100 people costs \$2.5 million, but leaving these criminals on the streets costs \$4.6 million.

The effect of other forms of punishment such as parole, probation, intensive supervision, and electronic monitoring on the ultimate benefit-cost ratio is not even considered here and must be the next step in understanding more fully the economics of corrections.

At this point, we cannot conclude that a meticulous benefit-cost analysis (aided by improved data availability) would result in a ratio much greater than 1. While supporting the view that prison is useful, from an economic standpoint, for a portion of the criminal population, our results challenge the implication of Zedlewski's original work: that every available dollar of public money go into expanding prison capacity.

Even if we find that "prison pays" at the margin, it would not mean that every convicted criminal de-

serves prison; it would not mean that it is cost-effective to imprison every convicted felon; and it would not mean that it is more cost-effective to imprison offenders than to supervise them intensively in the community. Indeed, community-based intensive supervision programs are among our most promising, proven, and viable corrections options. Recent evidence that these programs do not work as well as had been hoped based on early studies should not divert efforts to improve and experiment with them.

What finding that "prison pays" *would* mean is that we have reason to make a balanced use of correctional sanctions, that imprisonment is not "too expensive," and that an affirmative response to the clear and present need for more prison beds is a necessary if unfortunate social investment that will probably pay dividends over time.

Cautions

Three issues may bias our estimate one way or the other. There is, of course, always the possibility that prisoners in a given survey might exaggerate (or understate) the level of criminal activity, or that the extrapolations built into the calculations might exaggerate or understate the actual level of criminal activity among prisoners in the sample. Yet this is the best we can do at this point. Other prisoner surveys have reported higher median figures, but nothing far out of line with our finding of 12. Our survey mimicked the 1987 RAND Second Inmate Survey to take advantage of its extensive before-and-after testing of the survey instrument for accuracy of responses. At a minimum, our work can be confidently compared with other work that has relied upon similar surveys, such as the RAND Corporation's and Zedlewski's.

Second, one might quarrel with the social costs per crime calculated by Cohen. The use of jury awards is questionable, but probably the closest one can come to capturing public valuation. It is easy to recalculate the

benefit-cost ratio using the reader's preferred measure of social costs.

The third consideration, the estimate of annual costs of incapacitation, is also contentious, but probably less so than the first two issues. One might argue that the national per prisoner per year estimate of \$25,000 is too low. Few states, however, report spending even that much; Wisconsin's most recent estimate, for example, is under \$20,000, and New Jersey reports just over \$22,000. Also, Douglas C. McDonald, in the most recent and sophisticated analysis of corrections costs available, places the average per prisoner per year figure at \$14,000 for operating costs. Using McDonald's correction for the underestimation of capital and indirect costs results in an approximation of yearly incarceration costs in the \$20,000–\$25,000 range.

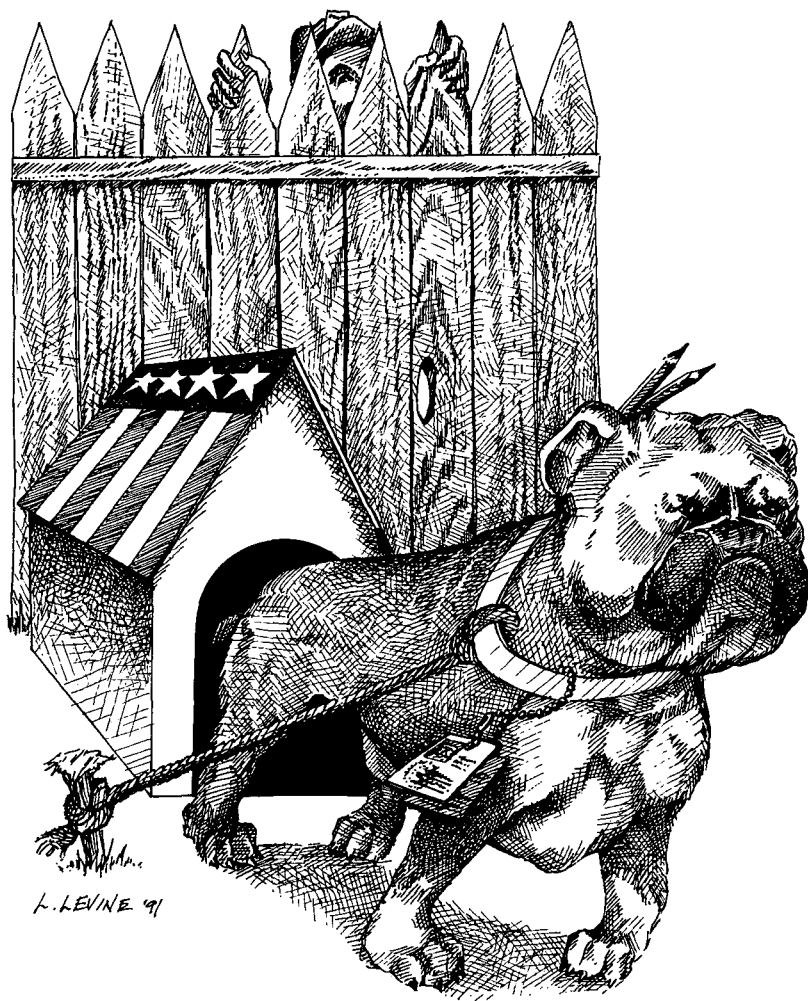
Calculating Conclusions

We cannot currently claim that prison either pays or does not pay at the margin. The evidence is not overwhelming on either side. The often-heard argument that slightly changing the methodology will result in wildly variant answers to the question of the net benefit of incarceration is enough to cause even the most reasonable-minded person to mutter "Garbage in, garbage out." And even if one were to conduct a far more sophisticated study of the same subject, certitude about its findings would still be impossible.

But making imprisonment policy based on implicit assumptions about the criminal characteristics of prisoners is merely a path of lesser intellectual resistance. Getting a rough handle on the net benefit of imprisonment by the type of analysis presented above is a useful way of introducing a measure of rationality into debates about the future of corrections. Both those who insist that prisons are costless panaceas and those who shout that prisons cost "too much" resist such analysis because they prefer to make corrections policy in the dark. ■

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Watching the Watchdog



“It is hard to think of another occupation of comparable importance to society that exercises so little formal control over itself,” claim the authors of a journalism textbook. Given the perceived power of the press, especially in Washington, the question of who watches the watchdog, and how effectively, is increasingly pertinent. There are various informal avenues of media criticism, of course—ombudsmen or readers’ representatives on some papers, journalism reviews and learned journals, organized monitoring groups of both the political left and the right, popular letters-to-the-editor columns. But on Capitol Hill a unique journalistic watchdog oversees the work of the congressional press galleries.

Reporters who wish to be members of the galleries are subject to a formal policing mechanism. Four committees of the reporters themselves, one each for daily newspapers, periodicals, radio and television, and photographers, are elected by their peers. To those committees Congress gives almost absolute control over space and facilities in the Capitol and the power to hire and fire the staffs of the galleries. In return, the committees determine who gets press passes and can censure or withdraw the privileges of those who break their rules. The legislators thus avoid becoming the arbiters of journalists’ conduct, a responsibility that would be both politically and constitutionally hazardous.

These self-governing and virtually autonomous committees have been the children of necessity and pragmatic administration. Initially Congress itself determined the admission or banishment of reporters from its chambers. And there was always some tension. The reputations of Washington reporters in the nineteenth century were sometimes shady and occasionally deservedly bad. Addressing his colleagues from the floor of the Senate in 1839, Connecticut Democrat John M. Niles described them as “miserable slanderers, hirelings hanging on to the skirts of literature, earning a miserable subsistence from their vile and dirty misrepresentations of the proceedings here.” Sometimes the scribblers, guilty perhaps of misrepresentation or, what amounted to the same thing, outrageously partisan bias, were expelled from the Senate or House chambers. Sometimes congressional action was more stern. In 1848 a *New York Herald* reporter was arrested by the Senate for publishing the secret text of the Treaty of Guadalupe Hidalgo, which ended the Mexican-American War, and was confined to a committee room in the Capitol for more than a month.

By the last quarter of the nineteenth century, oversight of the press had become too burdensome for Congress. The numbers of Washington reporters had exploded with the rise of the penny newspaper, and case-by-case examination of credentials and complaints was impractical. To address the problem, Speaker of the House Sam Randall met with a group of reputable congressional journalists in 1877 to create a self-policing system.

Once the reporters were given the authority to determine who would be let in, they set about devising ways to make sure that others would be kept out.

Women were initially excluded by a rule requiring accredited correspondents to file their dispatches by telegraph (none of the 11 women reporters in the 1870s qualified). Blacks were excluded by a rule requiring that accredited reporters work for daily newspapers; blacks worked for weeklies. (The Senate Rules Committee forced the correspondents to revise this rule in 1947.) When radio reporters applied for membership in the 1930s, the print reporters refused them. The galleries were already too crowded, they claimed, and letting in the radio reporters would open the door for even less desirable groups. Led by Fulton Lewis, Jr., the radio broadcasters won separate galleries of their own in 1939 (now used by television broadcasters as well). Two years later, correspondents for the periodicals got their own House and Senate galleries; and the photographers' gallery was started in 1955.

Most of the committees' time is taken up with housekeeping chores such as deciding on the proper level of dues, reviewing problems of security in the Capitol, and approving designs for gallery cards. But because membership in a congressional press gallery is increasingly required by federal executive agencies as proof of gainful employment in the news business and therefore presumably of serious and ethical intent on the part of a reporter, the standing committees have been turned into credentialing bodies.

The basic criteria for membership, slightly different for each gallery, are that the applicants must be "bona fide correspondents of repute in their profession"; their principal income must come from a news organization that meets the standing committees' definitions of acceptability; and they must not engage in certain activities, notably "paid publicity or promotion work" or lobbying.

Although it has not happened often, members of the standing committees have been called upon to judge the professional ethics or reputation of a colleague. In 1962, for example, they took up the matter of an overly aggressive colleague who "gained entry by subterfuge" into the office of Rep. D. S. Saund of California, took a copy of a press release, and wrote and published a news story containing the text of the press release although the release had been embargoed. The committee adjudged the actions "unethical" and "prejudicial to the repute and privileges of members of the Congressional Press Galleries."

A reporter's conduct was again questioned in 1979, when the Standing Committee of Correspondents considered charges against Gary Schuster, of the *Detroit News*, of posturing as a Michigan congressman by riding a "For Congressmen Only" bus to attend the March 26 Mideast peace treaty signing on the lawn of the White House. This time the committee unanimously went on record as "strongly disapproving the conduct attributed to Mr. Schuster" and conveyed to him its "reproof." The committee also reprimanded syndicated columnist Jack Anderson in 1989 for carrying a gun and bullet into the Capitol. Anderson had defended himself on grounds that his purpose was "to save lives by dramatizing that the Capitol security system was vulnerable."

From the perspective of Congress a primary purpose of the Standing Committee of Correspondents has been to protect the legislators from lobbyists acting in the guise of reporters. For example, the committee found against Earl Voss, of the *Washington Star*, for having "accepted payment for an article from an agent of the Nicaraguan Government" (1963); against Jack Anderson for failing to report being a director of an airline (1964); and against Lester Kinsolving, then of the McNaught Syndicate, for having received corporate stocks from a lobbyist for South Africa (1977). On the other hand, in 1978 columnist James J. Kilpatrick was declared not to have broken the galleries' rules by writing for *Nation's Business*, a publication of the U.S. Chamber of Commerce, because there was no "promotion in the articles" and, therefore, this was a legitimate free-lance activity.

Of 21 enforcement actions taken by the Standing Committee of Correspondents between 1913 and 1983, all but two have come since 1951, suggesting that reporters are taking their self-policing responsibilities more seriously in recent years. Indeed, the most celebrated brouhaha came in 1989 when the Executive Committee of the periodicals galleries voted 4-3 to require members to file "an itemized list of public appearances, freelance articles or consulting work, giving the precise source—but not the amount—of income." *Roll Call*, the Capitol Hill newspaper, asked editorially, "Is it in the public interest to know that a reporter who is writing about oil companies has just taken a \$1,000 speaking fee from an association of petroleum producers?" The answer was "You bet it is," but that such revelations should not come from the files of the press galleries. Other critics of the regulation, such as Morton Kondracke of the *New Republic*, "fumed" (according to a *Washington Post* story) that this was "a privacy issue" and that the committee was "just a bunch of busybodies." The four committee members who had voted for the stricter disclosure rule were swept from office at the next election, and the offensive proviso was then repealed.

Making rules and regulations, the reporters have found, can be complicated and unfair. There are advantages to a case-by-case approach. There are also disadvantages: it is terribly time-consuming, because adjudicators continually reinvent the wheel. The reporters' committees have been attacked for failing to provide proper protections for those who run afoul of their rules.

Norman Isaacs, a distinguished editor, has written that "the most sacred cow in journalism's holy credo [is] its self-proclaimed right to reject any type of examination of its performance." Yet journalism organizations love to write codes of ethical conduct. They "have a nice ring to them," journalism educator H. Eugene Goodwin has stated. He has also noted that they always lack enforcing machinery. Within this context, then, it is only a small note, but perhaps notable nonetheless, that the reporters who cover Congress have had a self-policing mechanism in place for more than a century, a watchdog of sorts, and if hardly a junkyard dog, one that does occasionally bark. ■

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A Burdensome Legacy

The Reagan Administration's Trade Policy

P A U L A S T E R N

Congress, the executive branch, and the U.S. International Trade Commission all help shape U.S. trade policy. Presidential leadership, however, is critical if the United States is to continue on the path of trade liberalization charted in the 1930s and prevent domestic interest groups from taking over the trade policy process. In this regard, the Reagan administration deserves low marks for its stewardship of America's free trade tradition. Notwithstanding his free trade rhetoric, Ronald Reagan was unable to resist the politics of protectionism.

At the root of the Reagan administration's trade troubles was its chosen macroeconomic policy mix—a loose fiscal policy, which resulted in record budget deficits, and a tight monetary policy, which kept interest rates high. Interest rates had started to shoot up in the late 1970s, but their stinging effects continued through the deep 1981–82 recession. Among the worst casualties were the heavily cyclical auto and steel industries, whose international competitiveness had already been slipping in the 1970s.

The high interest rates also sent the dollar's exchange rate soaring. While the strong dollar facilitated the financing of the U.S. fiscal deficit and helped to fight inflation, it compounded the trade woes of American industry, making imports cheaper in the U.S. market and exports more costly overseas. Record-breaking trade deficits rocked U.S. industries and workers, and pressures for protection mounted.

The administration's response to those pressures was to talk tough and spurn the existing structures for dealing with trade complaints, but, in private, to capitulate and to make special arrangements for politically important industries. As David Stockman, the president's Director of the Office of Management and Budget, put it, the strategy was to “espouse free trade, but find an excuse on every occasion to embrace the opposite. As time passed, we would find occasions aplenty.”

To be sure, Reagan's second term showed improvement, be-

ginning with the September 22, 1985, Plaza Accord decision to join with U.S. trading partners to allow the dollar to depreciate. The new team of trade policymakers—Treasury Secretary James A. Baker III and U.S. Trade Representative Clayton Yeutter—began to take steps to open markets abroad rather than protect them at home. The administration concluded negotiations for a U.S.-Canada Free Trade Agreement and launched the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) multilateral trade talks.

But it was too little, too late. By the mid-1980s the genie of protection was out of the bottle.

Rules versus Politics

The United States has two systems for dealing with trade complaints. Broadly speaking, the first system is “rule-oriented,” while the second is “political.” The rule-oriented system is intended insofar as possible to be free of politics. When members of an industry allege “unfair” competition, the relevant statutes require investigations by the International Trade Administration (ITA) of the Department of Commerce and by the U.S. International Trade Commission (ITC), an independent agency. In this system, criteria are set, transparency prevails, decisions are made on the record and are all sanctioned by multilateral covenants under the GATT. All industries and all countries, large and small, get their day in court. Procedures are definite, and all litigants are aware of them.

Most investigations involve allegations of unfair and injurious competition from subsidized imports or dumped imports (imports sold at less than fair value) and are intended to ensure “fair” pricing. Complaints are filed under antidumping and countervailing duty statutes (Title VII of the Tariff Act of 1930). Once a complaint is made, the ITA rules on whether dumping or subsidization has in fact occurred as alleged. The ITC rules in a parallel investigation on whether a petitioning domestic industry is suffering “material” injury as a result of dumped or subsidized imports.

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for the 1990s



If the ITA and the ITC both make positive determinations, a dumping or countervailing duty is applied to remove the unfair advantage of the import. The ITA determines the level of the duty based on the margin of “unfair” activity it has found. Another arm of the executive branch, the Customs Service of the Treasury Department, collects the duty.

The International Trade Commission is specifically equipped to shield Congress and the president from political pressures. Founded in 1917 as the Tariff Commission, it was designed by progressives to “take the tariff out of politics.” The politics, however, did not come out right away. Under the U.S. Constitution the president manages foreign affairs and Congress regulates foreign commerce. Both the president and Congress play important roles in developing international trade policy, and, not surprisingly, the Tariff Commission found itself caught in the middle when elected officials—driven by constituent concerns—either urged import restraints (for domestic interests) or import liberalization (for foreign policy or diplomatic reasons).

Changes in the law, particularly in 1974 and 1979, increased the agency’s independence, especially of the White House. The Trade Act of 1974 required that the ITC budget go directly to Congress without passing the scrutiny of the Office of Management and Budget. In addition, the act stipulated that members of the Commission be appointed by the president, with the advice and consent of the Senate, for nine years—one year longer than any president can sit in the White House. An appointee cannot be reappointed by the president, so decisions at the Commission need never be made with the thought of pleasing or displeasing the White House or Capitol Hill. The chair rotates every two years between the parties, and the president may not designate either of his last two appointees to be chair—again as a way of insulating Commission decisions from diplomatic pressures that might be transmitted through the White House.

Even so, the ITC is not entirely divorced from the political process. Appointments, of course, are made by the White House. Congress—particularly the chairmen of the Senate Finance Committee and the House Ways and Means Committee—tries to influence the appointment process. During the Reagan presidency, the White House attempted to tip the party balance and strengthen White House control over the Commission through the timing and designation of members and the chair. On at least one occasion Congress objected to White House manipulation of the rules for selecting members and designating the chair, and the chair eventually rotated as the statute had originally envisioned.

The very fact that the ITC conducts its “unfair imports” investigations in tandem with the ITA, which is part of the executive branch, suggests that the “rule-oriented” process itself is neither entirely mechanistic nor divorced from the political process. Rules on unfair imports leave room for judgment and discretionary behavior on the part of politically appointed decisionmakers. Moreover, import relief procedures may be vulnerable to political manipulation since the same office both investigates the allegations and decides the issue.

The Political System

In the overtly political system for resolving trade disputes, the decisionmakers are elected officials who are directly exposed to political muscle. Within this system, the guidelines are obviously less clear.

Both Congress and the president can operate outside the confines of the formal trade laws. For its part, Congress can pass new laws to supersede the old—if the president goes along and does not veto the changes. Presidents can and have used their

constitutional authority to persuade foreign governments to limit their exports to the United States and have established administrative mechanisms to implement the restraints. President Johnson did so in 1968 to forestall congressional legislation that would limit carbon and alloy steel imports into the U.S. market. Both Japan and the European Community agreed in December 1968 to a three-year voluntary restraint agreement for their steel exports. Subsequently, President Nixon renewed the steel agreements. In January 1978 the Carter administration began monitoring the price of steel imports through a “trigger price” mechanism. The trigger price was the estimated landed costs of the world’s most efficient producer—at that time, Japan—for imported steel. If a foreign producer sold steel in the United States below that price, formal antidumping proceedings would be initiated by the ITA and the ITC.

The Reagan administration, however, took unprecedented advantage of the political system. Without the encumbrance of statutory standards, it unilaterally decided what imports were “fair” or injurious in a number of significant trade cases. At times, the political system simply swamped the rule-oriented system.

The Political Pressures

Throughout 1981–85, as U.S. industries staggered under the burden of a soaring dollar, burgeoning import competition, and declining exports, the Reagan team talked “free trade.” It seemed to disregard the effect of the superdollar on U.S. manufacturing and on farm sectors exposed to foreign competition. By the mid-1980s the perception was rife that the administration was neither adequately nor consistently using the means to defend U.S. trade interests that Congress had authorized in earlier legislation.

One congressionally sanctioned trade remedy authorized the administration to take a variety of actions to improve access to foreign markets. Section 301 of the Trade Act of 1974 provided the president with tools to open foreign markets to U.S. products. It allowed the president to open negotiations with any country that unfairly burdened or restricted sales of U.S. goods in its markets. If negotiations were unsuccessful, the United States could retaliate by imposing tariffs or quotas. But, especially during its first term, the Reagan administration virtually ignored its authority to bring section 301 cases.

Another remedy was Trade Adjustment Assistance, which provided maintenance payments and job retraining to workers who lost their jobs because of import competition. Created in 1962 to gain labor’s support for the Kennedy Round of the GATT multilateral trade talks, TAA was enlarged and liberalized in 1974 to win labor support for the Tokyo Round. During 1974–80—under Presidents Nixon, Ford, and Carter—merchandise imports more than doubled, and the numbers of workers receiving TAA grew significantly. Republican critics claimed that TAA was used by the Carter administration to gain labor support in the 1980 election, and many neutral observers noted that TAA was not fully doing the job of retraining workers or dampening pressures for protectionism. In any event, after Reagan took office, he persuaded Congress to eliminate funding for TAA.

But at the same time that the administration criticized or ignored the trade laws and adjustment programs developed by Congress, it was negotiating “voluntary” agreements with U.S. trading partners to limit imports in a few politically important industries.

Automobiles

In 1980, at the end of the Carter administration, the United Auto Workers and Ford Motor Corporation petitioned the ITC for import relief. The autoworkers had already petitioned for TAA, and

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approximately \$1 billion was paid to autoworkers who lost their jobs because of imports.

In the ITC automobile investigation, unfair trade was not even alleged. The ITC acted on the petition for relief under section 201, which provides for investigation of cases of injury from *fairly* traded imports. In this case, the ITC issued a negative section 201 finding: imports were *not* the most important cause of serious injury. But the administration ignored the finding and the law. For the first and only time ever, a president chose to ignore the political shield the ITC provided and proceeded to provide protection for an industry found *not* injured by imports.

In the spring of 1981 support was growing in Congress for automobile import quotas, domestic content legislation, and sectoral reciprocity in conducting trade relations. Some have argued that Reagan had no choice but to bow to congressional pressure. But in 1981 the president was basking in his overwhelmingly large electoral mandate and was still in his honeymoon period with Congress. Had Congress enacted a quota or domestic content bill—something it never did—he had the political clout to veto it and to beat back any attempt to override the veto.

Reagan, however, had another agenda. According to David Stockman's 1986 account, on March 3, 1981, Transportation Secretary Drew Lewis announced in a Cabinet Council meeting that “the time had come to ‘keep faith with our campaign pledge’ to restrict Japanese auto imports.” And sure enough, the following May the Japanese “did mysteriously ‘volunteer’ to limit their auto exports to 1.68 million vehicles.”

The voluntary restraint agreements with the Japanese auto industry were in effect through 1984 and brought U.S. automakers

some \$9 billion in added revenue. But an ITC study in 1985 showed that Japan earned an extra \$5 billion as well. The Japanese renewed the VRAs unilaterally for a fifth and again for a sixth year, giving us the new trade phenomenon of “monolateralism,” or pre-emptive self-imposed protection for one's ailing trading partner.

Steel

In October 1984, one month before the presidential election, the administration again ignored the ITC, this time dismissing a section 201 affirmative finding of import injury *from fair competition* on several categories of carbon steel. Instead, the administration's negotiators concluded voluntary restraint agreements with 27 different countries, *expanding* the categories of steel to include specialty steel. The administration also muddled the distinction between fair and unfair competition by justifying its VRA quotas as a necessary response to “unfair” import competition in steel.

William Niskanen, one of three members of the president's Council of Economic Advisors, has candidly acknowledged the politics surrounding the decision: “As was characteristic of the 1984 campaign, the administration was on both sides of this issue, articulating a policy of free trade and implementing an extensive set of new import quotas.”

The upshot of the decision was the same as in the case of autos. One of the country's most politically influential industries gained protection from imports in a way that deviated from congressionally sanctioned rules that call for temporary relief extended on a nondiscriminatory basis.

Again, both Congress and the White House lined up on the side of import relief. But Congress attempted to move beyond

mere protection to encourage long-term adjustment. At the urging of the United Steelworkers of America, it passed the Steel Import Stabilization Act requiring that any cash flow derived from import relief be reinvested into modernization and retraining workers. The act required the president, the ITC, and the U.S. Trade Representative to monitor the reinvestment. The administration initially opposed the legislation, which it perceived as “industrial policy,” but eventually ironed out a compromise.

Renewed Congressional Assertiveness

The beginning of wisdom for the Reagan administration was the admission, after the president’s 1984 reelection, that the superdollar had compounded the problem of restoring U.S. economic competitiveness. In coordination with its chief trading partners, the United States hammered together the Plaza Agreement in September 1985, bringing heavy pressure on an already declining dollar. The administration also began to pursue section 301 market access trade cases to open markets abroad.

The rhetoric changed after the president’s reelection. “Fair trade” replaced “free trade” and became the cloak of new forms of import protection for other industries. But whereas the trade statutes that are on the books were eschewed before the 1984 election, the administration stretched its mandate—once again undermining the rule-oriented system—by self-initiating or reopening previously closed investigations (of allegedly dumped semiconductors and subsidized lumber) when political pressure to do so mounted.

By that time, however, Congress had lost its confidence in the administration’s ability to handle trade policy. The result was the

Omnibus Trade and Competitive Act of 1988, the first congressionally initiated major trade bill since the Smoot-Hawley Act a half century earlier.

Many provisions of the new law were meant to prod the administration into taking a more assertive trade posture, particularly in opening foreign markets to U.S. exports of goods and services. For example, to force the administration to use its section 301 authority, Congress restricted (but not absolutely) the president’s freedom *not* to retaliate if a negotiation with a foreign trading partner breaks down. Furthermore, Congress took from the president the job of deciding when and how to act on section 301 petitions and gave it to the U.S. Trade Representative.

Several other provisions of the 1988 act also reflected Congress’s desire to encourage long-term adjustment and to establish a more formal process for seeking exchange rate stability. For example, the president was required to seek negotiations with other countries to better coordinate macroeconomic policies, reduce trade imbalances, and stabilize exchange rates. In addition, the Treasury Secretary was required to identify periodically any countries that manipulate their currency’s exchange rate relative to the dollar and to seek bilateral agreements to eliminate these unfair advantages. Moreover, a Competitiveness Policy Council consisting of representatives from business, labor, government, and academia was authorized to identify economic and social problems affecting U.S. competitiveness and recommend coordinated long-term strategies for dealing with these problems.

Even though the trade bill was a repudiation of the Reagan administration’s trade policy, it was also, ironically, an unmistakable sign of Reagan’s influence on U.S. trade policy in the 1980s. In

Reagan administration trade policies during the 1980s were costly both in terms of results and in terms of processes. The Reagan team’s neglect of existing trade laws and rules has saddled the United States with a political, economic, diplomatic, and legal legacy that future administrations and Congresses must dismantle.

passing the bill, Congress took up the Reagan team's explanation for America's trade problems—namely, “unfairness”—and its solutions—namely, heavy reliance on protection.

Legacies of the Reagan Era

By the time President Bush took office, U.S. industries were convinced that political muscle was the trade tool of choice at both ends of Pennsylvania Avenue. By granting import relief in ways that exceeded its legal mandate or skirted conventional import regulatory practice, the White House had legitimized efforts to use politics—not necessarily economic merit or legal criteria on “injury” or “unfair competition”—and opened the door wider for special interest pleading to replace national interest as the basis for making U.S. trade policy.

But, although the costs to the nation's consumers had risen as a result of the protection offered to politically powerful industries, the industries themselves had not necessarily been able to regain a competitive edge. Protected producers had been able to increase profits or even market share in the short term, but had not made the necessary longer-term adjustments. The voluntary restraints on automobiles actually intensified the competitive challenge to the Big Three U.S. automakers by accelerating the foreign direct investment of Japanese manufacturers in the United States. The Big Three have continued to lose market share to Japanese nameplates (imported as well as made in the United States). Japan's share of the U.S. car and truck market increased from 21.2 percent in 1980 (when the petition was filed) to 23.4 percent in 1990. As the Japanese automobile voluntary restraint agreements tapered off, the industry returned to Washington this summer for antidumping relief on minivans.

The consequences of the steel voluntary restraint agreements were similar. In 1988 steel industry profits were high and the mills were running at full capacity. Average steel prices, however, had increased as much as 40 percent since 1985, thus penalizing and jeopardizing the customer base on which the steel industry relies. Steel-using manufacturers such as makers of appliances, machinery, metal products, and transportation equipment experienced significant VRA-induced shortages that disrupted their production schedules. As soaring steel costs ate at their profits, the ability of these steel users to modernize and export were stifled. According to a study by the Center for the Study of American Business, the voluntary restraints on steel saved 17,000 steel jobs but cost 52,400 in other industries. The Reagan administration had abdicated its chance to insist on fundamental changes necessary to equip U.S. industry to compete by improving performance. And it had further undermined American competitiveness and led to lost sales in domestic and international markets.

By appearing to give low priority to trade regulation—particularly in its first term—and giving short shrift to trade remedies and adjustment that the law provided, the Reagan administration had set into play a movement among restive casualties of its 1980s economic policies to dismiss the legal framework for dealing with import competition—particularly section 201—or at the most to use it to set the stage for a political assault on the White House.

The crescendo of Reagan administration claims of “unfair” trade to justify market intervention in cases where no unfair trade had been demonstrated had also confused official and public thinking about the purpose of the trade laws. The general public had come to believe that the biggest U.S. trade problem was the unfairness of our trading partners. In fact, despite hundreds of claims of “unfairness” from U.S. industry in the 1980s, only a tiny fraction of U.S. imports is affected by antidumping and countervailing duty investigations. The precise figures for the past several

years are two-tenths of 1 percent of imports during 1987, four-tenths of 1 percent during 1988, and two-tenths of 1 percent during 1989.

The public had also been given the false impression that protection, especially against unfairly traded goods, will solve a given industry's problems. In fact, often an industry's most important problems are not unfair competition and may not even be overseas competition, whether fair or not. The source of the industry's problem may very well be internal or exacerbated by government rules and policies that have unintended consequences for industry. Import problems, therefore, may be more symptoms than causes of an industry's lack of competitiveness.

Looking Ahead

Reagan administration trade policies during the 1980s were costly both in terms of results—consumer costs and lost opportunities for responding to increasing international competition—and in terms of processes. The politicization of trade policy and the retreat to unilateral protectionism diminished intellectual support for the rule-based multilateral system. The Reagan team's neglect of existing trade laws and rules has saddled the United States with a political, economic, diplomatic, and legal legacy that future administrations and Congresses must dismantle.

What will be the impact of that legacy over the next few years? Political pressures for protection tend to flourish under certain conditions. During presidential campaigns, candidates are particularly anxious to please special interests. When the trade deficit increases, so do sectoral calls for protection against foreign competition. When unemployment is on the rise, that too brings cries for relief. Unemployment has risen to 7 percent, and the United States is entering the 1992 presidential sweepstakes. And although the trade deficit has fallen from \$152 billion in 1987 to about \$75–\$85 billion in 1991, it is projected to hit triple digits again in 1992.

This past year the United States confronted the recession that it had avoided for nearly eight years. And now the timing and characteristics of a recovery preoccupy the nation. The best way out of the recession is through a strong surge of exports. An export-led strategy for recovery has the added virtue of improving America's trade deficit. But the feasibility of rekindling the U.S. export boom that began in 1987 and is now slowing depends a great deal on the dollar's value and the relative growth rates in the major export markets of Europe and Japan. Unfortunately, the dollar's value has increased 20 percent since January, and other major economies are slowing too. As long as the dollar does not climb too high and U.S. exports stay price competitive, and as long as Japan and Europe grow briskly and are receptive to American goods, this strategy can work.

If the export-led growth strategy fails, George Bush will face reelection in a recessionary—or weak recovery—environment with unemployment high, if not rising, and the trade deficit projected to grow.

Bush, the internationalist, could use a debate on approval of the Uruguay Round of GATT trade talks to begin to reverse the Reagan legacy. He could channel protectionist pressure into a multilateral trade treaty that would open markets abroad. That would give him the opportunity to paint any Democratic opposition to the Uruguay Round—should it develop—as the economic equivalent of opposition to use of military force in the Gulf war.

In the end, Bush, like every president before him, has the power to channel congressional concern and ultimately shape America's trade policy. The question is not one of political power, but of political will. ■

A CLOSE CALL FOR FREE TRADE

American Business Returns to the GATT Fold

BILL FRENZEL

Last December the unthinkable happened. Negotiations on the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) broke down. After four years of talks, trade ministers from the world's leading trading countries had been unable to come to agreement.

Agriculture was the main sticking point. The European Community had refused to accept more than token reductions in agricultural subsidies and barriers. There were other unresolved problems besides agriculture, but they were secondary. Anyway, it was the failure, not the reasons, that stunned the world. GATT rounds are not supposed to fail.

The Uruguay Round was intended to be the eighth consecutive liberalizing round since the GATT was founded in 1948. Its failure was considered unacceptable, even by the European Community, on whose intransigence it foundered. So the painstaking work of restarting the negotiations began as soon as possible. It was obvious, however, that a resolution that had eluded negotiators for four years was not going to be found swiftly. A quick fix was neither possible nor desirable.

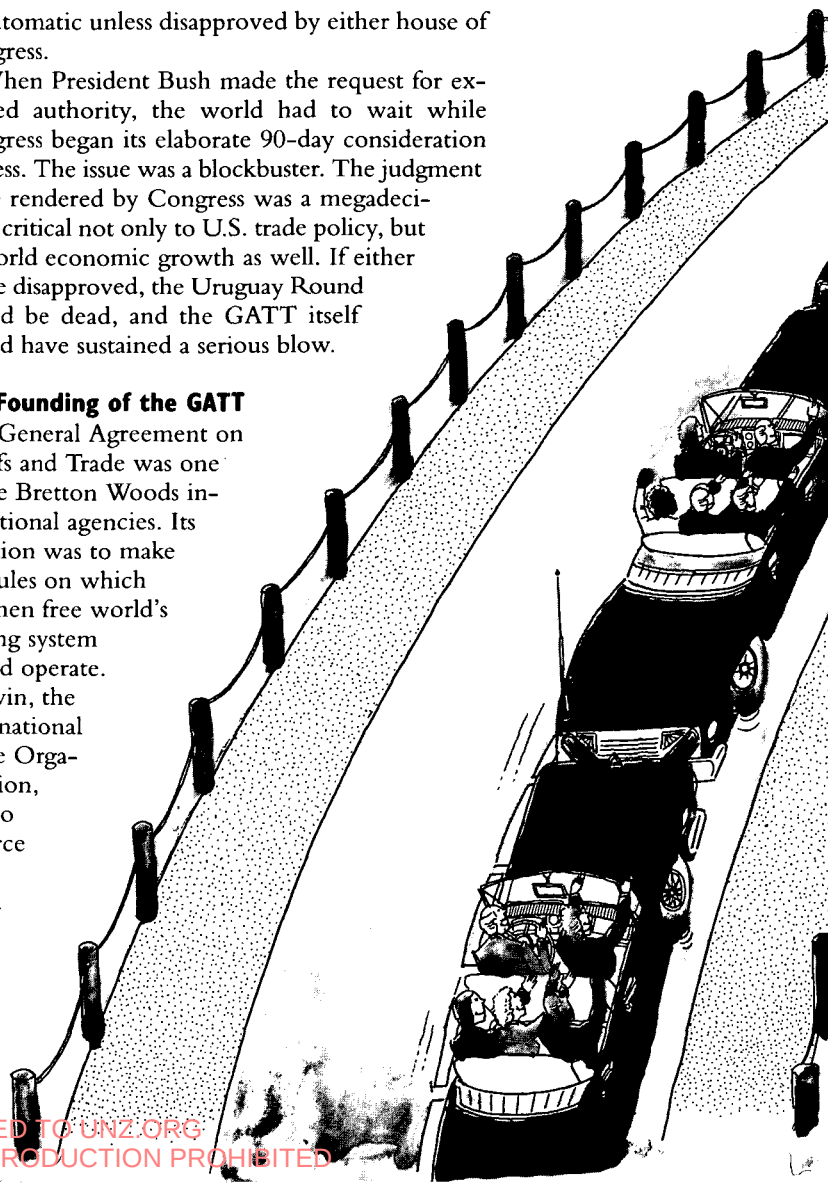
The world's trade ministers and their governments were keenly aware that U.S. negotiating authority would expire at the end of March. Under the U.S. Constitution, Congress controls trade policy. In practice, it is more of a ratifier than an initiator. In recent years it has given the president specific authority, limited in time, called the "fast track," to negotiate and to present the results to Congress for ratification in unamendable form. The Trade Act of 1988 that granted the expiring authority also contained a provision for extending it. At the president's request, a two-year extension would

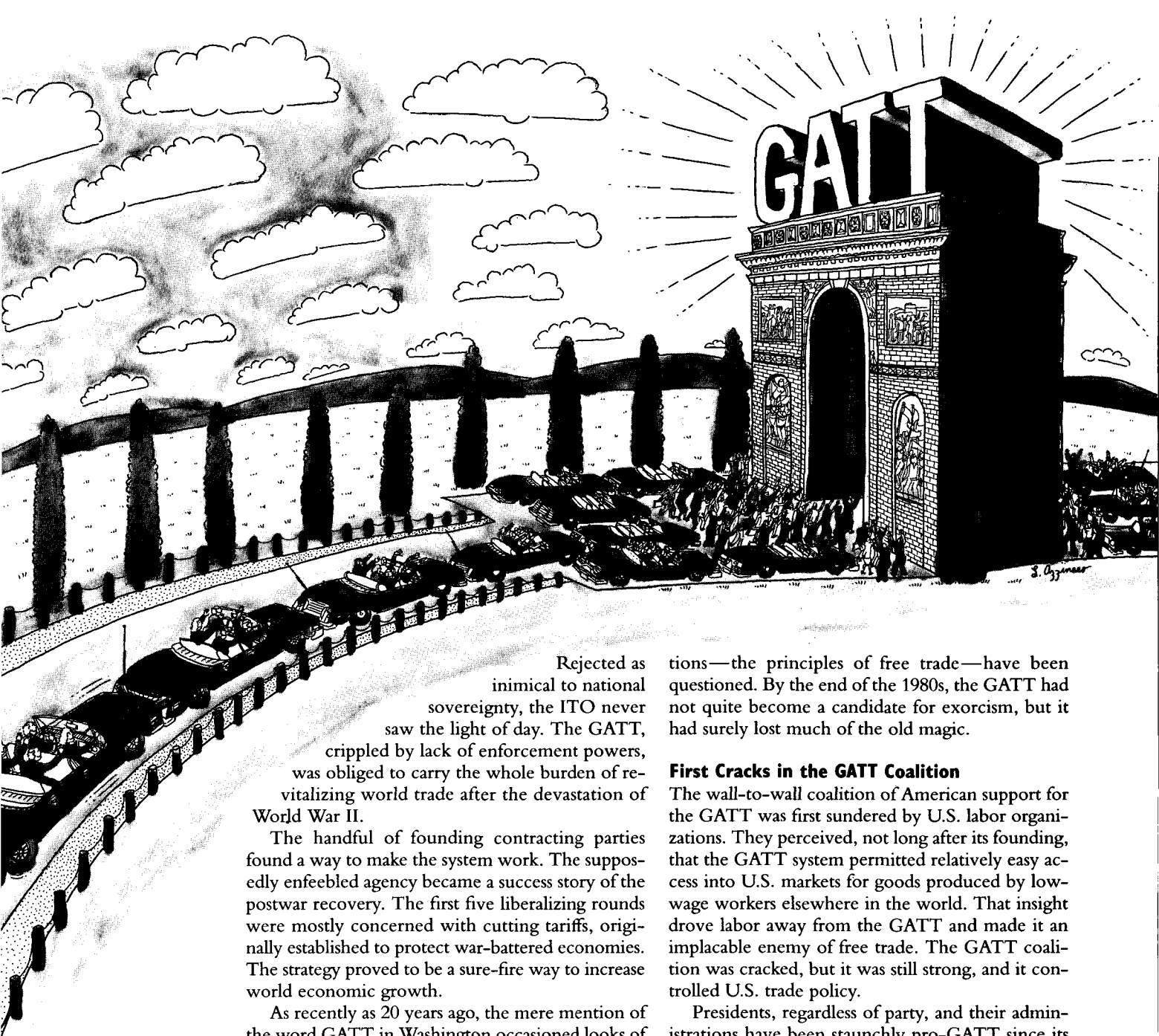
be automatic unless disapproved by either house of Congress.

When President Bush made the request for extended authority, the world had to wait while Congress began its elaborate 90-day consideration process. The issue was a blockbuster. The judgment to be rendered by Congress was a megadecision, critical not only to U.S. trade policy, but to world economic growth as well. If either house disapproved, the Uruguay Round would be dead, and the GATT itself would have sustained a serious blow.

The Founding of the GATT

The General Agreement on Tariffs and Trade was one of the Bretton Woods international agencies. Its function was to make the rules on which the then free world's trading system would operate. Its twin, the International Trade Organization, was to enforce the rules.





Rejected as inimical to national sovereignty, the ITO never saw the light of day. The GATT, crippled by lack of enforcement powers, was obliged to carry the whole burden of revitalizing world trade after the devastation of World War II.

The handful of founding contracting parties found a way to make the system work. The supposedly enfeebled agency became a success story of the postwar recovery. The first five liberalizing rounds were mostly concerned with cutting tariffs, originally established to protect war-battered economies. The strategy proved to be a sure-fire way to increase world economic growth.

As recently as 20 years ago, the mere mention of the word GATT in Washington occasioned looks of awe. The American business community, or such of it as operated offshore, and government policymakers in both the legislative and executive branches had genuine affection, as well as reverence, for the free world's trading system.

And why not? The General Agreement was our baby, a creature of American postwar economic policy. Based on the principles of the Reciprocal Trade Act of 1934, it was the symbol of free trade. Especially when compared with the managed trade policies of the nonmarket economies, it seemed the very best example of the free world's economic promise. Whatever its original flaws, the United States and the world had good reason to like it: it worked.

Over the past two decades, however, the GATT's reputation, its effectiveness, and even its credibility have eroded. The GATT's very founda-

tions—the principles of free trade—have been questioned. By the end of the 1980s, the GATT had not quite become a candidate for exorcism, but it had surely lost much of the old magic.

First Cracks in the GATT Coalition

The wall-to-wall coalition of American support for the GATT was first sundered by U.S. labor organizations. They perceived, not long after its founding, that the GATT system permitted relatively easy access into U.S. markets for goods produced by low-wage workers elsewhere in the world. That insight drove labor away from the GATT and made it an implacable enemy of free trade. The GATT coalition was cracked, but it was still strong, and it controlled U.S. trade policy.

Presidents, regardless of party, and their administrations have been staunchly pro-GATT since its founding. Congress, if it had any doubts about executive branch recommendations, looked to business, not labor, as its trade policy adviser. When George Meany thundered against ratification of the Kennedy Round in 1974, Congress listened politely, but did not heed his advice. Instead, it followed the counsel of the U.S. business community and the U.S. Trade Representative, Ambassador Bill Eberle. Ratification was not all smooth sailing, but ultimately the negotiations were approved by large congressional majorities.

Again in 1979, when the Tokyo Round was pending in Congress, labor was a vigorous opponent, working against Ambassador Bob Strauss, then U.S. Trade Representative. Even so, the issue was never in doubt. The business community delivered strong support, and Congress responded with strong majorities in favor of the agreement.

Bill Frenzel, a Brookings guest scholar, retired from the U.S. House of Representatives in 1990 after representing Minnesota for 20 years. He served on the Ways and Means Committee, where he specialized in trade and tax issues.

*Protectionism
has a
timeless,
addictive
appeal . . .*

More severe blows against the free trade coalition and the GATT were the early, and sometimes successful, bids by major industries for special domestic protection. The textile industry, heavily protected by high tariffs since the birth of the republic, was able to force other protections, including the 1974 Multi-Fiber Agreement. Steel and autos were successful in the late 1970s and early 1980s, respectively, with trigger-price mechanisms and voluntary restraint agreements.

All these mechanisms were theoretically voluntary, and each administration that negotiated them alleged that they conformed to the GATT. They may have been politically necessary to prevent worse protectionism, but they carved great holes in the normal discipline of the GATT. In addition, their success, although often partial, made the system more vulnerable to subsequent attacks from other interests seeking trade relief.

By the 1980s business protectionism was no longer an isolated phenomenon. Machine tools, auto parts, agricultural producers, and even high-technology groups had joined the parade toward more vigorous U.S. unilateral protection. Like their predecessors in textiles, steel, and autos, these groups perceived themselves as abused victims of unfair trade tactics. They believed the GATT and their government had failed them.

Their battle cry was "fair trade"; their symbol, the uneven playing field. Alleging unfair practices by trading partners, most often Japan, the protesters continued battering the GATT, usually without even mentioning it. In fact, most efforts to avoid the normal strictures of the GATT by making U.S. law more protectionist were not successful. But each weakened the GATT support level a little more, and each encouraged another future claimant to become a little bolder in seeking relief outside the GATT.

Cumulatively, these efforts convinced Congress and the nation to begin to believe that U.S. trade policies had been naive and that the United States needed a more aggressive trade policy. The uneven playing field had become an imposing symbol. The GATT was not failing, but its flaws were becoming more evident.

No wonder American industries were complaining. The 1980s was a period of unrelenting disaster for U.S. trade. Everything went wrong. Exchange rates were ruinous. Debt problems destroyed our traditional hemispheric markets. The U.S. fiscal deficit skyrocketed. Our economy went on a spending binge. Domestic producers experienced unrelieved miseries. None of these problems was within the reach of the GATT, but the free trading system of the world was taking the heat.

The Trade Acts of 1984 and 1988

Business people who had worshipped at the altar of the GATT in its glory days became its sternest critics and demanded changes in U.S. trade laws. Real relief was not to be found until the end of the decade when the dollar weakened, but that did not diminish

congressional enthusiasm to try to change trade laws.

The Trade Act of 1984, developed well before the worst of the trade deficits, was Congress's first response to the business calls for relief. Both houses passed bills containing GATT violations, but when the two met to reconcile differing provisions, the anti-GATT language was removed thanks to the resourceful work of Ambassador Bill Brock, then U.S. Trade Representative. The administration had defended its trade policy and the GATT, but there was no doubt that the 1984 act was the harbinger of worse to come.

Congress began work on another, tougher trade bill the next year, 1985, although it took until 1988 to enact it. The four-year wait did nothing to improve Congress's disposition. In 1987 the trade deficit peaked at about \$170 billion. Japan's trade surplus with the United States that year was some \$70 billion. Business was hurting. Congress was itching for a fight. It was not at all afraid of violating the GATT, and it was ready to test the limits of the veto power of a lame duck president.

No amount of administration resourcefulness could keep the 1988 act free of protectionist provisions contrary to the GATT. Nevertheless, Ambassador Clayton Yeutter, U.S. Trade Representative, worked mightily and almost performed the miracle. Some of the traditional friends of free trade were working against him. Some others were not helping. Indeed, American business had little incentive, except for the vague hopes for the recently undertaken Uruguay Round, to help him.

Most GATT member states thought that the 1988 act was contrary to the General Agreement. Although Ambassador Yeutter succeeded in making changes so that a very clever and very strong future administration could administer the act without violating the GATT, the legislation put strong pressure on the administration to be more aggressive in its trade policy. In the hands of a protectionist administration, it could be very disruptive to the GATT system.

The Uruguay Round

When Ambassador Carla Hills, the current U.S. Trade Representative, began negotiating the Uruguay Round early in 1989, she was representing an ambivalent, cautious, and sophisticated business community. The painful lessons of the 1980s loomed large. The major business players were not going to project enthusiasm until every possible objective listed in the 1988 Trade Act had been won in the negotiations. Hills bargained with skill and caution, rejecting the last-minute EC offer of a mini-agreement just before the talks broke down. Without a comprehensive agreement, business would almost certainly advise against ratification.

With U.S. trade policy at the crossroad, Hills had to convince Congress that the traditional free trade-GATT course was best for the United States. When, at the end of March, the president made his request for extended negotiating authority, the outcome was in doubt. What 20 years ago would have

been a piece of cake was now nip and tuck. Conventional Washington wisdom said the odds favored disapproval.

Congress's Decision

By the time the president requested the extension, labor had already been at work in Congress for two months. It was well organized and committed. It had the early momentum, especially in the House of Representatives, the chosen battleground. It also chose to focus its opposition on the North American Free Trade Agreement, involving the United States, Canada, and Mexico, rather than the Uruguay Round, in the belief that it was easier to defeat.

Business, meanwhile, was waking up from the pessimism of the 1980s and finally noticing a two-year-long export boom. The December breakdown of the round had also gotten its attention. Instead of worrying about getting a little more out of the round, business was thinking now about getting nothing. That was an unpleasant prospect. Congress's favorite trade advisers were returning to the fold. They were not, and might never be again, the happy campers of the 1960s and 1970s, but neither were they the belly-achers of the 1980s. Business finally decided it wanted, or needed, Uruguay and NAFTA, and was willing to work for them.

In April, lobbying was intense. Labor, and its principal ally, textiles, focused on Mexico, its labor rates and conditions, and its environmental problems. An *ad hoc* House whip group organized by House Trade Subcommittee Chairman Sam Gibbons (D-Fla.) to support the president's request could count but 100 votes out of 435 when it met the first time.

Ambassador Hills, for the administration, spent most of her waking hours meeting with Congress. When the chairmen of the congressional committees of jurisdiction, Senator Lloyd Bentsen (D-Texas) and Congressman Dan Rostenkowski (D-Ill.) wrote to the president inquiring about controversial questions raised by opponents of NAFTA, she led the interagency group that produced the reply. That response, persuasively argued in person by Hills and Environmental Protection Agency Administrator Bill Riley, effectively laid to rest the environmental issue. Even Congress could understand we were unlikely to make Mexico cleaner by keeping it poor.

The votes came the last week in May. The motion to disapprove the president's request was defeated by a 40-vote margin in the House and even more handily in the Senate, which had never been a problem. No landslides these, but each represented a comfortable margin.

The 600-pound Gorilla

There is no reason to believe that the unpleasantness of the 1980s has been forgotten. New uneven playing fields will be discovered or invented. Protectionism has a timeless, addictive appeal. It may have peaked, or stabilized, but few would dare to make that prediction. So far, there have been no calls for repeal of the Trade Act of 1988.

American business has emerged from the fast track controversy as an even stronger player in U.S. trade policy. But it is not easy to deal with. It is the 600-pound gorilla. It cannot be taken for granted. It is not always going to be pro-GATT, especially in hard times. And it is not above seeking a little unfair advantage from time to time. Administrations in the future will have to be even more careful in dealing with business, even more assiduous in communicating on negotiations, and even more cooperative in framing the issues it takes to Congress.

New opportunities for business-government cooperation have opened, but they will not be easy to grasp. Because administrations typically give commercial values lower priority than geopolitical values, and because business typically takes a rather short-term, heterogeneous point of view, it will take big issues and big people to realize the big opportunities.

The Future

Now that the vote on negotiating authority has set the direction of U.S. trade policy for the 1990s, the first two opportunities, Uruguay and NAFTA, are self-evident. The latter, with three willing negotiators and strong business support, looks like a cinch. Because it is complicated, it will take time, but the issue is not in doubt. The former, the Uruguay Round, is an uphill battle. If the European Community remains adamant, there will be no agreement.

The other opportunities are less obvious. As the world lurches toward its now only dimly glimpsed "new order," a few things are clear. East-West confrontation will change, and intense global commercial competition will take its place on center stage. The United States, with its array of strong security forces, is well positioned for yesterday. For tomorrow, our position—defined by endless fiscal deficits, low saving rates, persistent trade deficits, a sick banking system, and a set of foreign policy disincentives against doing business abroad—is lousy. The closest business-government cooperation will be required to reposition our economy and amend our regulations to meet the international competition of the future.

Finally, even if the United States can become more competitive, it will still have to look beyond internal management to some kind of international forum for uniform rules on factors that accelerate or decelerate trade, but that are still beyond the reach and competence of the GATT.

Some of these trade-driving factors are exchange rates, whimsically monitored by the Group of Seven; export financing, covered by a "gentlemen's agreement" in the Organization for Economic Cooperation and Development; tax systems, blissfully unsupervised and uncompanied; and international security expenses, currently burdening U.S. products with extra costs. If that short list seems discouraging, it helps to remember that the road to free trade has never been easy. Without the ITO, the GATT was not expected to survive back in 1948. And the vote on the negotiating authority looked like a loser in March. ■

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Accidental Nuclear War?

BY BRUCE G. BLAIR



The abortive coup staged by Soviet hardliners in mid-August raised fears of an unauthorized launch of nuclear ballistic missiles and thereby provided an unwitting boost for a U.S. plan to deploy an anti-missile system called Global Protection Against Limited Strikes (GPALS). GPALS had already been set in motion only two weeks earlier, when the majority of the Senate voted to field an anti-missile defense by 1996.

Championed by Senators Sam Nunn and John Warner, the Senate plan would deploy 100 missile interceptors at a previously deactivated anti-missile installation in North Dakota. It also calls for President Bush to renegotiate the 1972 Anti-Ballistic Missile (ABM) treaty so that as many as five more sites, each with 100 interceptors, could be deployed for added protection. And it earmarks funds for a new space-based sensor network ("brilliant eyes") and for redoubled research and development on space-based interceptors ("brilliant pebbles"). Although the Senate blueprint is ambitious, its language is couched to enable the United States to pursue an effective limited defense against missile attack without unilaterally breaching the ABM Treaty.

The Senate's vote responded to the Bush administration's re-orientation of the "Star Wars" program in the wake of the Gulf War. In place of the original vision of an anti-missile defense capable of blunting a deliberate massive Soviet strike, the administration substituted a scaled-down defensive umbrella that could handle a small accidental or unauthorized missile attack. Inspired in part by the drama of Patriot missiles intercepting Iraqi Scud missiles, proponents of GPALS claimed that with 1,000 space-based "brilliant pebble" interceptors, 750 ground-based interceptors,

and 60 "brilliant eye" satellites—at an estimated cost of about \$40 billion—the United States would be effectively protected. According to the director of the program, GPALS would be able to destroy all but a handful of the 200 Soviet nuclear warheads that could be lofted against the United States in the worst plausible case of unintentional Soviet attack. Unlike the Senate plan, the Bush-backed version of GPALS would entail withdrawing from rather than renegotiating the ABM Treaty.

An intense debate has begun over the technical feasibility of GPALS, its true cost, its priority in an era of defense belt-tightening, and the likely effect of modifying or abrogating the ABM Treaty on Soviet strategic modernization and on U.S.-Soviet relations. The debate will have a familiar ring about it, because it will echo the earlier Star Wars controversy. The one big difference is that the premise of GPALS is an accidental small-scale launch of Soviet ballistic missiles.

How realistic is the alleged danger? The attempted Soviet coup does raise the possibility of a breakdown of coherent, competent leadership at the very apex of the central government. But if a breakdown of that scale produced an attack, it would as likely be a massive strike as a very limited one.

How realistic is an unauthorized attack launched by missile commanders far down the chain of command? Are Soviet safeguards strict enough to prevent the illicit firing of a regiment of land-based ballistic missiles or a boatload of submarine missiles? It appears that the Soviet government has gone to extraordinary lengths to preclude these possibilities.

The key feature of the Soviet nuclear command system is its high degree of centralization. In essence, the system ensures that

no single individual, including the president, can authorize the use of nuclear weapons. Both the top political leadership and the high military leadership must independently generate special codes and transmit them to a facility of the General Staff, where the codes are combined, encrypted, and transmitted down the chain of command. Without these codes, the strategic missile crews cannot physically launch their weapons.

Despite such stringent safeguards, absolute assurance that they would remain reliably effective for all 10,000 warheads in the Soviet strategic missile arsenal under conditions of acute domestic crisis cannot be given. The danger of civil war in the Soviet Union should thus encourage the nuclear powers to strengthen safeguards. The U.S. Congress has already requested the Pentagon to report on the feasibility and merits of a variety of new measures to reduce the risks and consequences of accidents and unauthorized events. These approaches represent sensible, cost-efficient solutions to the nuclear risks at issue. They deserve serious consideration by all the nuclear powers.

A heavier burden of proof falls on those who claim the solution lies in ballistic missile defenses. The next test of the GPALS solution occurs this October, when the Senate plan is assessed in conference with the House, whose members have drafted a defense bill that provides far less support for anti-missile programs. ■

*Bruce G. Blair is a senior fellow in the Brookings Foreign Policy Studies program. He has just completed a book on U.S. and Soviet nuclear safeguards, *The Logic of Accidental Nuclear War* (Brookings, forthcoming).*

The Soviet No-Man's-Land

BY BARRY P. BOSWORTH



In the long run the Soviet Union has enormous potential for economic growth. It has a large and unusually well-educated population. Unlike Eastern Europe, it is exceedingly rich in raw materials. But, for the moment, it is caught in a no-man's-land between a command and a market-based economy. Plant managers have been cut loose from the central planning system, but as yet have no system of market incentives to guide their production, financing, and employment decisions. Despite the breathtaking political events that began unfolding in August, the economy is at substantial risk of collapsing into a downward spiral of incomes and jobs.

One big problem has been that the Soviets could not agree on whether the republics or the central government would control the reform process. The inability of the union and the republics to agree on the division of tax revenues, for example, led to an explosive increase in the public sector deficit, which is now equal to 15–20 percent of GDP. The deficit is being financed by money creation, and the country is on the verge of extreme inflation. The failed coup has tilted the balance of power to the republics—though there remains a huge Soviet army to be supported as the central government withers away.

Economic production has fallen nearly 10 percent over the past year. The disappearance of goods from state stores seems obvious testimony to a decline in production, and so it is, though not necessarily in the way one would expect. What the empty store shelves show most compellingly is the extent to which trade now takes place through the back door. The good news is that private employment is expanding. Employment in small-scale

cooperatives and private enterprises is estimated to be about 5 million. The bad news is that far too many of those enterprises focus on the large profits that can be made by exploiting the inconsistencies of the state pricing system (speculation), rather than by producing goods.

The challenge is to manage a transformation to a private market without precipitating a collapse. Unlikely as it may seem, one promising model for the Soviets to follow may be China. As a result of reforms extending over more than a decade, 60 percent of China's gross domestic product and 40 percent of its industrial output are now produced outside the state sector. China is also the only socialist country to combine the transformation to private markets with rapid economic growth.

The Chinese path to market reform largely avoided the thorny Western ideological debate over the conversion of existing state enterprises to private ownership. Instead, the Chinese recognized that their future lies with new private firms, which they allowed to emerge side-by-side with the state enterprises. They also pursued a staged process of encouraging private firms in agriculture, service, and light manufactures, while leaving the large-scale basic material industries temporarily with the state enterprises. By gradually reducing control of state enterprises, the Chinese can subject them to increased market discipline and ultimately convert them to private ownership. So far China has seen significant gains in the efficiency and quality of the output in both the private and state sectors.

Realistically, the Soviets will also have a two-tiered economy for many years to come. The costs of massive and abrupt change, such as occurred in

eastern Germany, are too large. The existing large firms embody all the bad habits and attitudes of the past 75 years; and, as the Germans have learned, they are not attractive candidates for sale to the private sector. These enterprises are unlikely to be a source of future growth under any form of ownership. Yet they represent too large a base of current employment to let them flounder in the short run. Even in our own country, efforts to convert large defense plants to civilian use after World War II largely failed, and we were far more successful in allowing workers to move to new enterprises. Despite the political appeal of drastic change, a process of incremental reform like China's could suit the Soviet situation quite well.

Is there any way for Western governments to support political and economic liberalization in the Soviet Union? We cannot and should not try to develop a Soviet reform program. We know little more than they about how to do it. And any program of economic transformation must be a Soviet creation, not something forced on them by Western governments who would be held responsible for the problems and hardship that are bound to emerge in future years.

Offering some sort of financial assistance is also problematic. A successful conversion will depend overwhelmingly on the process of change within the Soviet economy, and any foreign currency aid that could feasibly be offered will make only a marginal contribution. At this stage the Soviets will benefit most from exposure to Western ideas of management and entrepreneurship; and that suggests an emphasis, as with China, on access to global markets and joint ventures with Western firms. ■

Barry P. Bosworth is a senior fellow in the Brookings Economic Studies program. He is currently at work, with Gary Burtless, on Private Saving: Why Has It Declined? (Brookings, forthcoming).

The Democratic Opposition

BY THOMAS E. MANN



Thomas E. Mann is director of the Governmental Studies program at Brookings and author of "Breaking the Political Impasse," in Setting National Priorities (Brookings, 1990).

Differentiating governing and opposition parties in American politics has seldom been a straightforward matter. Separation of powers and federalism diffuse, not concentrate, authority, providing opportunities and incentives for politicians of both major parties to think of themselves as part of the government. In recent years divided party control of the presidency and Congress has forced the Democrats into a seemingly permanent supporting role—the junior partner in a governing coalition whose influence on policy comes at the price of blurring its identity as the opposition party.

The decline of the Democratic presidential party (five losses in the last six elections and an embarrassingly small set of presidential aspirants 14 months before November 1992) has put intense pressure on the congressional leadership to abandon its "cohabitation" with George Bush and assume a much sharper partisan profile. Speaker Thomas Foley, whose accession to the top party post following the forced resignation of Jim Wright was greeted with universal acclaim, is now routinely criticized for being too bipartisan, accommodating, and consensual, for being unwilling to bang heads to produce a coherent Democratic alternative with which to contest the 1992 presidential election.

Critics, however, greatly exaggerate both the ability of congressional leaders to rally the opposition and the effect that tactical maneuvering on Capitol Hill can have on presidential elections. A more realistic assessment may suggest some possibilities for constructive steps that can be taken by the majority party in Congress.

Congress has an institutional responsibility to pass legislation, and it does so with impressive productivity—even in periods

of apparent deadlock between the branches. Yet whatever the value of those legislative accomplishments, they have little bearing on the public standing of the majority party in Congress. A bountiful legislative harvest does little to enhance Democratic presidential prospects.

Presidential elections are moved by forces largely beyond the influence of party leaders on Capitol Hill. The state of the economy, the nation's international standing, the president's reputation among voters, the images of the parties, and the quality of the opposition party nominee and his campaign overwhelm efforts in Congress to reposition the Democratic party on more favorable terrain.

The president has a huge advantage over congressional leaders in framing the terms of political debate and avoiding any traps they set for him. A president with an unambitious domestic agenda is in a particularly strong position to avoid full-scale combat on unfavorable ground. The Democrats' political victory in the budget deficit negotiations last fall, when the debate switched from whether to raise taxes to whose taxes to raise, was the exception that proves the rule. Only when a president needs positive action from Congress does he compromise that advantage.

It is naive to think that a large, heterogeneous legislative party can compete successfully with the president in shaping a national political debate. The comparative advantage of Congress—and the basis of its formidable legislative power—is disaggregation and specialization. An effective presidential challenge, on the other hand, requires unity of purpose and broad political themes.

Party leaders in Congress are in no position to impose policy

coherence in the absence of some rough consensus among the rank-and-file. Economic populism, for example, may look irresistible as a Democratic theme to campaign consultants, but when given legislative form it quickly generates controversy and opposition among members of the congressional party. To those who ply the legislative craft, the devil is in the details. Asking members of Congress to abandon their interests, preferences, and judgments about good public policy to advance an opposition strategy with little likelihood of payoff is futile.

A Democratic presidential nominee will have to carry the fight to George Bush in 1992. What Democrats in Congress can do is lay the groundwork for a Democratic administration when that opportunity next presents itself. An unexpected economic downturn next year could put the Democrats in the White House. Much more difficult to imagine is how they would govern if lightning struck. Confronting their party's weaknesses and the country's problems will require some serious, unconventional thinking that goes well beyond clever tactical maneuvering to embarrass the president.

In formulating proposals for unemployment insurance, middle-class tax cuts, health care financing and economic revitalization, congressional Democrats would be well advised to apply a simple test: does it provide a credible basis for successful leadership by a Democratic president? For better or worse, congressional Democrats are a part of the government, not the embodiment of its political opposition. There is relatively little they can do to improve their party's prospects in the presidential election. Let them at least be the source of some clear thinking about how the Democratic party might lead this country to

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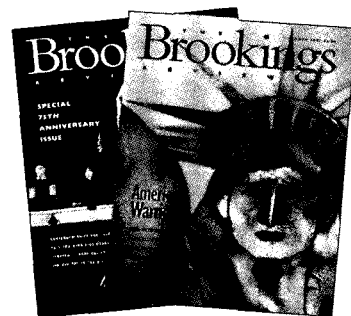
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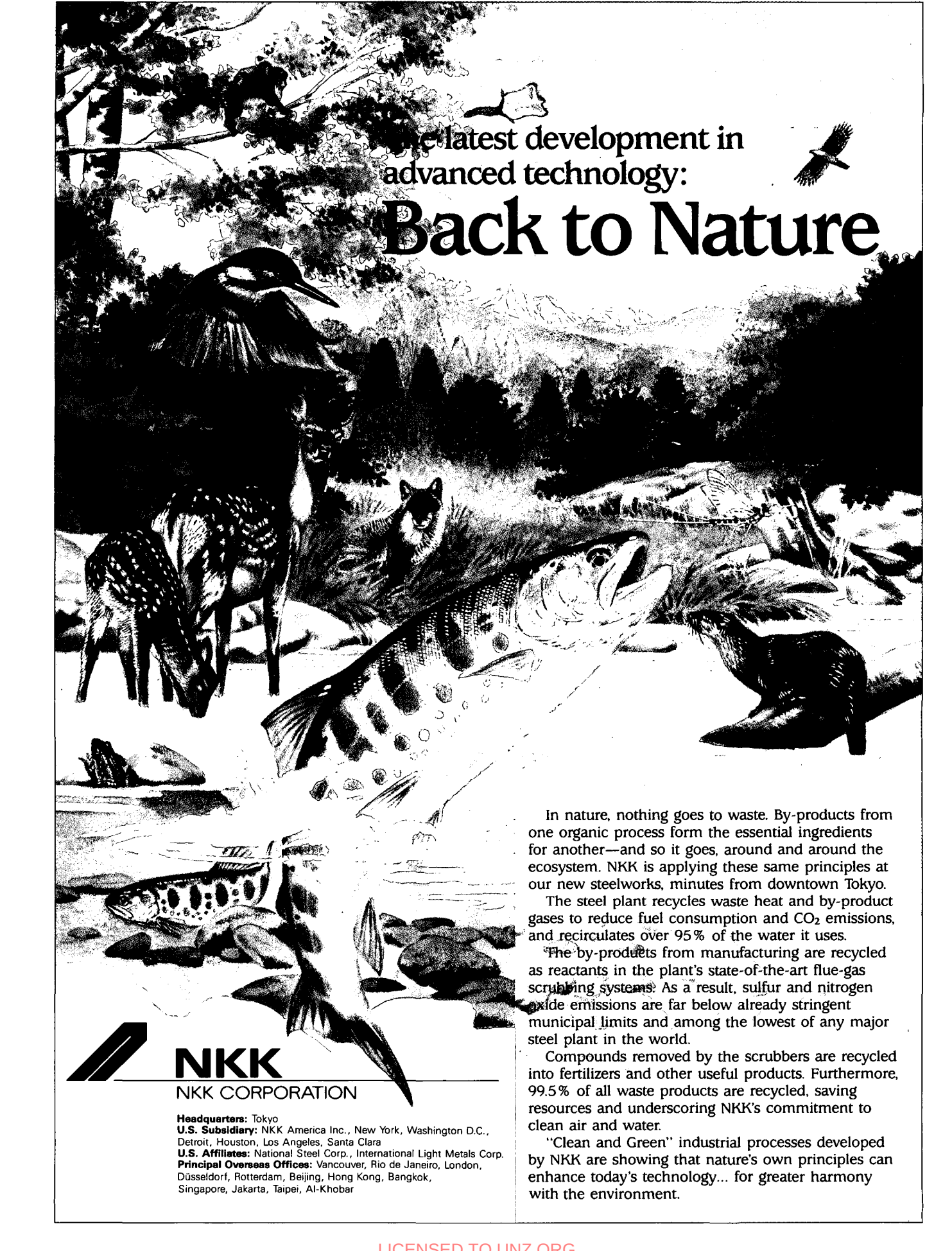
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